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No. 108

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1957

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

WM. FLEMING, ET AL

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

P. G. LAKE, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR WM. FLEMING, ET AL and P. G. LAKE, INC.

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COMMERCIAL RECORDER, FORT WORTH, TEXAS—2-21-58—70.

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court in the *Fleming* case (R. 142-155) are reported at 24 T.C. 818. The opinion of the Court of Appeals (R. 180-189) is reported at 241 F. 2d 78.

The opinion of the Tax Court in the *Lake* case (R. 13-14) is reported at 24 T.C. 1016. The opinion of the Court of Appeals (R. 16-27) is reported at 241 F. 2d 71.

JURISDICTION

The judgments of the Court of Appeals in these two cases were entered on February 1, 1957 (*Lake* case, R. 27; *Fleming, et al*, R. 190). The petition for a writ of certiorari was filed April 17, 1957 and was granted June 3, 1957. The jurisdiction of this Court rests upon 28 U.S.C. Section 1254.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 and Treasury Regulations are set forth in Appendix A hereto, *infra* pages 72-83. They are as follows: Sections 23(m) 112(a) and (b)(1) 114(b)(3); and 117(a)(1)(4)(8)(10)(b)(c) and (j)(1)(2); and Sections 39.23(m)-1(a)(b) and (e) and 39.112(b)(1)-1 of Treasury Regulations 118.

QUESTIONS PRESENTED

The *Fleming Case* presents two questions:

(1) Each of the taxpayers (respondents) in the *Fleming* case was engaged in the business of producing oil and had owned for a period of years various interests in commercial producing oil and gas leases and producing oil royalty interests, holding these for productive use in business. In 1948, one group of these taxpayers carved limited overriding royalty or oil payment interests out of several of these leaseholds and one royalty interest, and conveyed them to a third person in exchange for ranch lands and as the sole consideration therefor. In 1949, another of these taxpayers, having owned for a period of years for productive use in his business, commercial oil and gas leases, carved limited overriding royalty or oil payment interests out of some of these leases and conveyed the carved-out interests to a third person in exchange for urban real estate and as the sole consideration therefor. In each case, the taxpayers acquired and held for investment the real estate they received in these exchanges.

The first question is, whether the court below was correct in holding that these exchanges were of properties of like kind within the purview of Section 112(b)(1), Internal Revenue Code of

1939, so that no gain or loss is to be recognized for tax purposes because of the exchange.

The second question, to be reached in the *Fleming* case only if the holding of the court below on the non-taxable-exchange question is reversed, is whether the gain resulting to the Fleming group from the said exchanges is to be taxed as long-term capital gain or as ordinary depletable income from the properties from which the oil payments were carved.

The *P. G. Lake, Inc.* case presents only the second question involved in the *Fleming* case. The taxpayer (respondent was engaged in the business of producing oil. In 1950, it assigned to its president, a limited overriding royalty or oil payment interest out of two commercial oil and gas leases (which it had owned for several years), in satisfaction of an indebtedness then owing by the taxpayer to him, and reported the gain resulting from this transaction as long-term capital gain. This treatment was upheld by the court below. The question is whether this holding is correct, or the gain represented ordinary depletable income from the leaseholds out of which the oil payment interests were carved and conveyed.

STATEMENT

Both cases originated in the Tax Court as the result of deficiency determinations to the effect, in the

Fleming case, that the exchanges gave rise to recognized gain taxable as ordinary income with an allowance for percentage depletion; and in the *Lake* case, that the gain was not taxable as long-term capital gain but was taxable as ordinary income with a similar allowance for percentage depletion. The Tax Court upheld the Commissioner's determination on the nontaxable-exchange question in the *Fleming* case, but held that the gain was taxable as long-term capital gain. It reached a similar conclusion on the capital-gain issue in the *Lake* case. On petitions for review, the court below held in the *Fleming* case that both exchanges came within Section 112(b)(1) of the Internal Revenue Code of 1939, so that no gain was to be recognized therefrom, and then stated:

> "If we assume that we are in error in this view, and we, therefore, reach the third issue (capital-gain issue) * * * raised on the Commissioner's appeal, that the Tax Court erred in holding that the transactions were exchanges of property giving rise to capital gains treatment and not anticipatory assignments of income, we find ourselves in agreement with the Tax Court, and for the reasons set out in *Scofield* v. *O'Connor* and *Lake* v. *Commissioner*, this day decided, we affirm its judgment on this issue." (R. 187)

The Court below affirmed the Tax Court on the capital-gain issue involved in the *Lake* case.

All pertinent facts in each case were stipulated. The basic facts in these cases as summarized in pe-

titioners' brief (*Fleming* case, pp. 8-11; *Lake* case, pp. 5-6) are accurately stated, but there should be considered in connection therewith the following stipulated or undisputed facts:

The oil-payment conveyance from Fleming Oil Company to Mrs. Cline (the ranch owner) (R. 167-170), provided in part (R. 168):

> "Now, therefore, * * *, the undersigned, Fleming Oil Company, * * *, does hereby sell, assign and convey unto the said Mrs. Marie Hildreth Cline, * * *, the following-described real property, to wit:
>
> "An overriding royalty or mineral interest carved hereby out of the interest owned by Fleming Oil Company in each and all of the oil and gas leases described above, amounting to an undivided 49 128ths interest in and to all the oil in, under or that may be produced, saved and marketed from the above-described tracts of land, under the terms of the oil and gas leases covering the same, until the grantee named above shall have received therefrom oil of the net value of One Hundred Forty-Seven Thousand Dollars ($147,000.00), plus an amount equal to five per cent (5%) interest per annum from May 1, 1948, on the portion of said $147,000.00 which may be unsatisfied from time to time."

The instrument excluded from the interest conveyed gas or casinghead gas, as well as oil well

equipment, freed the interest conveyed from all costs of developing and operating the property, and the assignor from any express or implied obligation to see that the grantee received oil of the value specified and closed with the ordinary general warranty clause used in conveyances.

The other conveyances to Mrs. Cline (R. 170, 172, 175) were in substantially similar terms, as was the 1949 conveyance from Walsh to Cross, the owner of the urban property conveyed to Walsh (R. 177).

It was stated in the stipulation (R. 161) that:

> "On May 19, 1948, in accordance with a pre-existing agreement so to do, an exchange was consummated between Fleming Oil Company * * * on the one hand, and Marie Hildreth Cline on the other, by which Fleming Oil company * * * were conveyed by the said Marie Hildreth Cline * * * the fee simple title to some 2,994.5 acres of land * * * then used and suitable for ranching purposes. As the sole consideration for said conveyance, Fleming Oil Company assigned and conveyed * * * the limited overriding royalty or oil payment interests herein more fully described. These limited overriding royalty or oil payment interests came from oil and gas leases or oil and gas mineral interests, which the respective transferors had held and owned for considerably more than six months prior to the date of said transaction—May 19, 1948—for productive use in their respective trades and businesses and not for sale.

> The said ranch so acquired in said exchange by Fleming Oil Company, Wm. Fleming Trustee and Wm. Fleming was acquired by them, and each of them, for investment, and has been held for investment and not for sale, since said acquisition."

The stipulation contains a substantially similar statement as to the Walsh-Cross transaction (R, 165-166).

The oil-payment conveyance in the *Lake* case (R. 8-10), after reciting the ownership by P. G. Lake, Inc. of two oil and gas leases, continued (R. 9):

> "That P. G. Lake, Inc. * * * for and in consideration of the sum of Ten Dollars ($10.00) and other good and valuable consideration to it in hand paid by P. G. Lake * * * does hereby barbain, sell, assign and convey unto the said grantee, his heirs and assigns, such an interest in said oil and gas leases, and each of them, so that the said P. G. Lake, grantee, shall own twenty-five per cent (25%) of seven-eighths (7/8ths) of all oil and gas in, under or upon such leases and each of them, and shall be entitled to receive twenty-five per cent (25%) of seven-eighths (7/8ths) of all the oil, gas and other minerals produced, saved and marketed from the above-described oil and gas leases and leasehold estates, from and after 7:00 a.m. January 1, 1951, until said grantee, his heirs and assigns shall have received by virtue of this interest the sum of Six Hundred Thous-

> and Dollars ($600,000) net to him after the payment of all pipe line and gross production taxes attributable to said interest, plus an amount equal to interest at the rate of three per cent (3%) per annum, payable monthly on the entire unpaid balance of said original sum remaining from month to month unsatisfied."

It was then provided that the interest assigned should be free and clear of expenses of developing and operating the property, and grantor was to hold grantee harmless therefrom, and then stated (R. 10):

> "The parties hereto shall from time to time execute such transfer orders, division orders and instruments of like character necessary in order to carry into effect the terms and provisions of this conveyance and to facilitate the orderly handling, transportation and sale of the oil and gas produced from said leases."

This was followed by a provision that the interest conveyed was to terminate when the amount specified had been received by the grantee.

It was stipulated further (R. 10):

> "Following the execution and delivery of the instrument set out in the preceding paragraph by petitioner by P. G. Lake, transfer orders in the usual form were executed and delivered to the pipe line companies which were then running and purchasing the oil produced from the said properties, directing the payment to P. G. Lake of the

proceeds from the sale of twenty-five per cent (25%) of seven-eighths (7/8ths) of the oil and gas produced from said Reid and Owens leases, effective at 7:00 a.m. January 1, 1951, until he, the said P. G. Lake, had received oil and gas of the value specified in said instrument above set forth. In accordance with this order, the pipe line companies purchasing said oil and gas paid P.G. Lake directly for said share of the oil and gas, beginning with oil and gas produced during the month of January, 1951, and continuing until February, 1954, at which time the said P. G. Lake had received oil and gas of the value specified in the foregoing instrument."

SUMMARY OF ARGUMENT

I.

The oil payment assignments made by the Flemings and P. G. Lake, Inc. were conveyances of present interests in real property, not assignments of future income, because:

(a) The oil payments were part of, and carved out of the grantors' leasehold and royalty interests, everywhere recognized as real property;

(b) Such oil payment interests are likewise recognized as interests in real property;

(c) Each oil payment grantee acquired by investment a depletable economic interest in the real prop-

erty (oil reserve) owned by his grantor. This was true present ownership for the grantee could look only to oil when, as and if produced to recover his investment; the loss or destruction of the pertinent oil reserve without fault on the part of anyone would fall solely on the grantee; he, and he alone, could dispose of the interest by sale, exchange, gift or otherwise as he saw fit without liability to account to anyone; and it could be taken for the debts of grantee and not for those of any other person;

(d) The oil applicable to any of the oil payment interests was the income of the oil payment grantee when produced. This is evidence of true ownership because only the owner of property is taxable on its income.

(e) The oil payment assignee, and he alone, is entitled to an allowance against the oil payment income, because he alone has the requisite economic interest therein. This economic interest is actually ownership, whether evidenced formally as here, or informally as was true in some of the cases decided by this Court. Such depletion allowance is not available to one whose interest attaches to oil only after it is produced.

(g) Petitioners' theory of "assignment of future income" disregards the unique character of oil and other mineral holdings and tax principles long established by decisions of this Court.

II.

The Fleming exchanges of oil payment interests for lands were admittedly within the "non-recognition of gain or loss" provisions of Section 112(b)(1) I.R.C. of 1939, if the properties exchanged were of "like kind" as that term is used in this section.

The properties exchanged, though of different grades and qualities, were of the same nature and character in that both were realty. This, under regulations continued in force since 1921, is all that is required. The Courts have on several occasions expressly approved these regulations; Congress has at least inferentially done so by repeatedly reenacting the statutory provision without change.

The Court below is the only Appellate Court that has considered the precise problem. That Court has held Louisiana mineral interests and urban property, as well as a carved out oil payment and a landowner's mineral interest, to be properties of like kind, in addition to the holding here under consideration.

The Treasury has ruled that an exchange of an oil lease for land, as well as the exchange of a pepetual

water right for land, were exchanges of properties of like kind under Section 112(b)(1). These rulings reenforce the correctness of Fleming's position and the holding of the Court below.

III.

The Treasury's present position as to the proper method of taxing the gain from the disposition of carved-out oil payments is a complete reversal of its long-continued practice which had received judicial and congressional approval. This practice has thereby been so deeply embedded in the law that it could not be changed administratively.

Until 1946, the disposition of a carved-out oil payment of any duration (if other statutory requirements were met) was held to produce long-term capital gain. A ruling issued in that year attempted to exclude from this rule short-lived oil payments (those ordinarily having a duration of one or two years), but this ruling was not applied retroactively. A 1950 ruling attempted to bring all carved-out oil payments within the 1946 rule as to short-lived ones.

There had been no pertinent change in the capital gain provisions as repeatedly reenacted in various Revenue Acts, and the principle that the sale of a carved-out oil payment was a sale of an interest in the property and not productive of ordinary depletable income had been judicially determined.

The oil payments now under consideration were not "short-lived" but had durations of from more than three to twelve years.

The Treasury's "about face" is administrative legislation—forbidden by the doctrine of *U. S.* v. *Leslie Salt Company*, 350 U.S. 383.

Since the Fleming transactions were fully consummated in 1948 and 1949, before the 1950 adminstrative attempt to do away with the distinction between short-lived and longer oil payments was made, the Commissioner's action as to them had the added, and very serious, vice of retroactivity.

IV.

The taxpayers' conveyances meet every statutory requirement for long-term capital gain treatment of the resulting gain. Each came from, and was a part of, property which the grantor had held for productive use in his business for the requisite length of time. The statutory exceptions (stock in trade, etc.) are not applicable. Each transaction was a sale or exchange of a present interest in the property, not of oil after it had been produced or of future income.

This accords with all holdings of the Tax Court and of all of the Appellate Courts which have passed upon the question, except that in *Commissioner of Internal Revenue* v. *Slagter*, 238 F. 2d 901 (USCA 7th), the

correctness of which petitioners expressly disavow,—with principles announced by this Court, and general and local law on the subject.

V.

Petitioners' theories cannot be reconciled with the principles governing the allowance of depletion firmly established by decisions of this Court. Each oil payment conveyance vested a depletable economic interest (ownership) in the oil reserve in its grantee. Depletion on the oil payment yield to grantee cannot be denied. Such an allowance cannot be made to one whose rights in the oil attach only after production. Depletion is not allowable with respect to proceeds from the sale of an interest in property as distinguished from income from production. The determination of who has an economic interest (ownership) in an oil reserve controls both who reports the income from the interest and who is entitled to depletion with respect thereto. The two concepts are inseparable. Depletion cannot be allowed on more than 100% of the gross income from the production of a property.

Petitioners' theories violate all of these principles, in that, under them, depletion is allowed on the proceeds of a sale, and since depletion cannot be denied to the oil-payment grantee, the necessary result is an allowance for depletion on more than 100% of the gross income from the property.

VI.

The long-continued and admittedly correct tax treatment of similar transactions such as sales of leases with the retention of an oil payment, the carving-out and sale of unlimited overriding royalties, the sale by the retainer or grantee of any oil payment, and the re-allocation of the depletion required by such transactions, establishes the incorrectness of petitioners' position here.

These practices establish that a lessee's interest in an oil reserve can be divided between either an unlimited overriding royalty or an oil-payment interest and the remainder of the working interest; that each part continues to be a depletable economic interest and a capital investment; and that sales of any of these interests, except that now in dispute, that is; one accomplished by the carving-out of an oil payment, produce long-term capital gain if other statutory requirements are met.

There is no practical or legal basis for these distinctions. If the carving-out and sale of an oil payment is only an assignment of future income, so is the carving-out and sale of an unlimited overriding royalty. If one conveys a depletable economic interest, so does the other. If the carving-out and sale of an oil payment merely give the grantee the right to collect for grantor's oil, the reservation of such an oil payment in the sale of a lease merely gives the assignor the right to collect for assignee's oil.

The distinctions urged by petitioners are wholly arbitrary and unsound.

VII.

Petitioners' arguments are unsound. Contrary to these arguments:

(a) Each oil-payment grantee made the requisite capital investment;

(b) Each oil payment was a sale or exchange of income-producing property;

(c) By each oil-payment conveyance, its grantor realized on the increase in value of his capital investment;

(d) Each oil-payment interest conveyed was substantial;

(e) Each transaction was a sale, not a leasing transaction to which *Burnet* v. *Harmel*, 287 U.S. 103, applies;

(f) The "donative assignment of future income" cases are inapplicable;

(g) The Lake transaction cannot be treated as a debt payment with cash, nor can the Fleming transactions be treated as purchases for deferred cash payments; but if they could, neither petitioners' nor tax-

payers' position would be right, but the *Slagter* doctrine, disavowed by petitioners, would be applicable, and substantially all of the resulting income would be taxable in years other than those before the Court.

ARGUMENT

I.

The oil payment assignments made by the Flemings and P. G. Lake, Inc. were conveyances of present depletable interests in real property, not assignments of future income.

We are here dealing with ordinary commercial oil and gas leaseholds and, in one case, with an ordinary royalty interest. Such interests have always been, and are now, recognized as interests in real estate by the decisions of this Court,[1] by local law and decisions,[2] by all of the tax cases dealing with the subject,[3]

[1] *Waggoner Estate* v. *Wichita County*, 273 U.S. 113; *Thomas* v. *Perkins*, 301 U.S. 655.

[2] *Tennant* v. *Dunn*, 130 Tex. 285, 110 S.W. 2d 53; *Sheffield* v. *Hogg*, 124 Tex. 290, 77 S.W. 2d 1021; *Stephens County* v. *Mid-Kansas Oil & Gas Company*, 113 Tex. 160, 254 S.W. 290; *W. T. Waggoner Estate* v. *Sigler Oil Company*, 118 Tex. 509, 19 S.W. 2d 27. Particularly pertinent is the holding in *Tennant* v. *Dunn*, *supra*, extensively analyzed and commented upon by Judge Hutcheson in his opinion in the Lake case, R. 19-22, 23, 24, 25. Judge Hutcheson's long experience as a Texas lawyer and as a United States District Judge in the Southern District of Texas before he went to the Bench of the Fifth Circuit, where all types of cases involving oil and

and by Treasury administrative practices and rulings.[4] Such interests are property within the purview of *Section 117*, Internal Revenue Code of 1939, and are not excluded from the meaning of the term "property" as there used by any of the excepting provisions of said section.[5]

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gas were continually coming before him for consideration, gives added weight to his pronouncement on any phase of Texas Oil and Gas Law.

[3]A large number of Appellate Court tax cases are collected and summarized in Appendix C hereto, pp. 135 to 152, infra. See particularly *Fleming* v. *Commissioner*, 82 F. 2d 324, infra p. 147; *Ortiz Oil Company* v. *Commissioner*, 102 F. 2d 508, infra p. 138; *Commissioner* v. *Rowan Drilling Company*, 130 F. 2d 62, infra p. 145.

[4]Some of the pertinent administrative rulings are reproduced in full in Appendix B hereto. That the interest of a lessee in an oil and gas lease is real property is expressly held in *I.T. 3693*, infra p. 112-115, and other rulings reproduced in Appendix B hereto proceed upon the same theory.

[5]The definitions of "property" and "capital asset" contained in earlier revenue legislation dealing with the taxation of capital gains are modified in the Internal Revenue Code of 1939 (applicable here) to exclude from the definition of "property" contained in *Section 117(a)* of that Code, Appendix A infra, p. 74, "real property used in his trade or business", but *Section 117(j)* of the Code expressly allows capital gain treatment where gains are derived from the sale of "real estate used in his trade or business" but allows losses from such sales or exchanges to be treated—within certain limitations—as ordinary losses. So, since no losses are involved in the present cases, it is immaterial whether the taxpayers' oil interests be treated as property under *Section 117(a)* or as real property used in trade or business under *Section 117(j)* *I.T. 3693*, Appendix B, p. 112 infra, is to the same effect. The other exceptions to the definition of

Petitioners cannot, and we are sure will not, deny that the sale by any of the Fleming taxpayers or by P. G. Lake, Inc. of any of the properties to which the oil payment conveyances here involved relate, or an undivided interest in any such property continuing for the entire life of the property, would have produced long term capital gain taxable as such under said Section 117.*

Each conveyance involved in the Fleming and Lake cases was a conveyance of a true oil payment interest in the property to which the conveyance related,—that is, it gave to the assignee a right to a specified share of oil when, as and if produced, free of cost of developing and operating the property, and required the assignee purchaser to look only to the specified share of oil when, as and if produced for the recovery of his investment. Such an interest differs from an unlimited overriding royalty only in that it will not necessarily continue for the economic life of the property, but will terminate when, as and if the specified quan-

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capital assets contained in *Section 117(a)(1) I.R.C. 1939*, Appendix A, p. 74, infra, (stock in trade, inventoriable property, property held primarily for sale to customers, property used in business of a character which is subject to the allowance for depreciation, a copyright, etc., and certain obligations of the United States or its Possessions, or of other governmental agencies) are clearly not applicable.

*I.T. 3693, Appendix B, p. 112 infra. By stipulation each such property had been held for the requisite time and was held by its owner for productive use in trade or business and not for sale to customers. R. 8, 162, 166.

tity of oil, or oil of the specified value, has been produced for the account of its owner.

Further it is clear that the owner of an oil payment interest has a depletable economic interest in the property to which his oil payment relates. The decisions of this Court beginning with *Palmer* v. *Bender*, 287 U.S. 551, and continuing through *Commissioner* v. *Southwest Exploration Company*, 350 U.S. 308, conclusively establish that everyone who acquires by investment a right to share in oil when, as, and if produced for the recovery of his investment, has a deplet-

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[1]This has been the consistent view of the Internal Revenue Service. See *I.T. 4003*, Appendix B, p. 125 infra. Even in *G.C.M. 24,849*, Appendix B, p. 117, infra, which attempted to deny capital gain treatment to gain derived from the sale of a short-lived oil payment, it was recognized that the one acquiring the oil payment interest acquired a depletable economic interest in the oil and gas in place, see p. 119 infra. The statement in the petitioners' brief (footnote 17, p. 37) that: "It should be noted that, even if the assignments did convey an economic interest in the oil in place, the assignees would be entitled to depletion only on the excess of the oil payments over the amount paid for the assignments" is directly contrary to the long-continued and present practice of the Internal Revenue Service. This error has been called to the attention of petitioners' counsel and we are sure that at or before the argument counsel will admit that the statement is erroneous. The correct practice is to allow the oil payment holder depletion based upon cost or upon 27-1/2% of the oil payment holder's gross income from the oil payment, whichever produces the larger deduction, but not to allow recovery of cost (cost depletion) and then percentage depletion upon the excess over cost. This would be a double depletion deduction. See also, argument at page 55, infra.

able economic interest in the oil property. Further, this Court has expressly held that the same criteria which determine who is entitled to depletion with respect to oil produced determine who is the owner of the corresponding interest in the property. In *Anderson* v. *Helvering*, 310 U.S. 404, this Court said (Page 407):

> "It is settled that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable. That issue is, who has the capital investment in the oil and gas in place and what is the extent of his interest."

See, also, *Burton-Sutton Oil Co.* v. *Comm.* 328 U.S. 25.

The interest of an oil payment holder in the oil and gas reserve is a true ownership. One owns property of the loss from the destruction of the property without fault would fall entirely on him. One owns property if it can be taken for his debt and for that of no other person. One owns property if he has the power to dispose of it without liability to account to anyone. The rights of the grantees in the various oil payment conveyances here involved clearly meet these tests. Each grantee had unlimited power to dispose of his interest by gift, sale or otherwise, without liability to anyone. A catastrophe causing the loss of the oil re-

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*Cf. *Anderson* v. *Helvering*, 310 U.S. 404, where the holder of an interest somewhat similar to an oil payment interest had a right to look to sources other than oil and gas when, as and if produced, for the recovery of his investment.

serve or rendering it incapable of being produced would fall solely upon the grantee in such an oil payment conveyance to the extent of his interest, if the catastrophe occurred without the fault of another. It could be taken for his debt, but not for the debt of another.

The yield from each oil payment conveyance was, as this yield was received or accrued, the income of the oil payment holder. Here again is another compelling proof that the grantees in these oil payment conveyances were the owners of interests in the property, for the income from property is taxable to the owner of the property. *Poe* v. *Seaborn*, 282 U.S. 101; *Home Savings Bank* v. *Des Moines*, 205 U.S. 503. See also *Knowlton* v. *Moore*, 178 U.S. 41; *Hoepner* v. *Tax Commission of Wisconsin*, 284 U.S. 206 and *Nichols* v. *Coolidge*, 274 U.S. 531.

It is further established by the decisions of this Court that one whose rights to oil or gas attach after production as, for example, one who has a contractual right to take and process gas after it has been produced does not have an economic interest (ownership) in the gas reserve, and is, therefore, not entitled to depletion. *Helvering* v. *Bankline Oil Company*, 303 U.S. 362.*

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*This case involved the right to depletion of one who had by various contractual arrangements acquired rights to casinghead gas after it had been produced. Because Bankline Oil Company's rights did not attach until after production and it did not have an economic interest in the gas reserve or any part in the producing operation, the right to depletion was denied. Conversely when, as here, depletion must be

That an oil and gas leasehold estate can be divided into an oil payment interest and a working interest, consisting of the entire leasehold estate less the oil payment interest, and with all costs of development and operation attaching exclusively to such working interest, is clearly established by *Thomas* v. *Perkins*, 301 U.S. 655. There, although Perkins' assignors did not expressly reserve in their assignment any interest in the leaseholds, the assignment did provide for the payment to those assignors—

> "* * * of the further sum of Three Hundred Ninety Five Thousand Dollars ($395,000) to be paid out of the oil produced and saved from the hereinafter described lands, and to be one-fourth of all of the oil produced and saved from the premises hereinafter described until the full sum of Three Hundred Ninety Five Thousand Dollars ($395,000) is paid. * * * As hereinbefore stated, Three Hundred Ninety Five Thousand Dollars ($395,000) is to be paid to Mamie S. Hammonds and Fred P. Branson, each to receive one-half thereof out of oil produced and saved from said leased premises, which payment shall be paid by the Pipe Line Company or other purchaser of said oil, and shall be one-fourth of all of the oil produced and saved from the above described land until the full sum of Three Hundred Ninety Five Thousand Dollars ($395,000) is fully paid. * * *

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allowed to the oil payment holder on his income, it is necessarily established—contrary to petitioners' argument—that the oil payment holder's rights attached before production, were not assignments of oil after production or of the right to collect for the assignor's oil.

> *It is understood and agreed that said Three Hundred Ninety Five Thousand Dollars ($395,000) is payable out of oil only if, as and when produced from the land above described, and said payment shall not constitute and shall not be a personal obligation of the assignee* * * * (Emphasis supplied)

Under these facts, and despite the informality of the oil payment reservation, this Court concluded:

> "As Hammonds and Branson, the assignors in this case, would be entitled to an allowance for depletion in respect of the oil sold out of their share, the income from that interest is not chargeable to respondents, Perkins and wife. It follows that the Commissioner erred in including in their income the payments made by purchasers to assignors for their share of the oil."

Earlier in this opinion, in discussing *Palmer* v. *Bender*, *supra*, the Court said:

> "If Palmer had retained no interest in the oil, he would have been entitled to no deduction on account of depletion. Ownership was essential."

These established principles force petitioners to the position that although a depletable economic interest (ownership) in the nature of an oil payment interest can be retained in an assignment of an oil and gas leasehold, a similar interest cannot be carved out and conveyed with the retention of the remainder of the working interest and the burdens of operating and

developing; that such a carving out and conveyance is not an assignment of a depletable economic interest, but is of future income. But clearly there are no rules of conveyancing of local or general application which even hint at the proposition that a particular type of interest can be retained in a conveyance, but that the same type of interest cannot be conveyed out of the larger interest.

This Court's most recent decision dealing with oil properties and depletion fully supports what has been said above. In *Commissioner* v. *Southwest Exploration Company*, 350 U.S. 308, this Court dealt with a unique situation giving rise to conflicting claims for a depletion allowance. The Exploration Company, in order to acquire from the State of California and develop for oil production certain off shore areas, was required to obtain from riparian owners the right to conduct drilling operations by directional drilling based upon these riparian lands. To obtain such rights from the riparian owners, the Exploration Company agreed to yield to the riparian owners a share of the net profits from production. Both the riparian owners and the Exploration Company asserted the right to depletion with respect to so much of the income from the operation as went to the riparian owners as net profits. This Court upheld the right of the riparian owners to the depletion allowance and denied it to the Exploration Company, holding that, by the contract granting the Exploration Company the rights described, such owners had made

an investment and acquired a depletable economic interest in the oil reserves sufficient to support their claim for depletion. Except for the contract, the riparian owners were strangers to the title to the oil reserves. They must have acquired their interest from the Exploration Company, since they had no dealings at all with California. Therefore, the depletable economic interest which the upland owners acquired in this case must have come from the Exploration Company's leasehold rights. This was a carving out strikingly similar to the oil payment conveyances now under consideration. Under the principles governing the allowance for depletion announced and continuously followed by this Court since *Palmer* v. *Bender*, *supra*, the holding in the Southwest Exploration case that the upland owners were entitled to the depletion allowance is necessarily, as this Court expressly stated, a holding that these upland owners had an economic interest (ownership) in the oil and gas reserve.[10]

That the oil payment conveyances now under consideration conveyed present interests in the properties, as distinguished from future income, is of course the holding of all the Appellate Courts which have passed upon the question except the Seventh Circuit

[10]Under *Helvering* v. *Bankline Oil Company*, 303 U.S. 362—See footnote 9, p. 23 supra, the requisite economic interest (ownership) must have attached in favor of the riparian owners to the oil reserve *in situ* and not after production, otherwise these owners would not have been entitled to a depletion allowance.

in *Commissioner* v. *Slagter*, 238 F. 2d 901,[11] the correctness of which petitioners expressly disavow, of the Tax Court in every case in which that Court has considered the question,[12] and accords with State law. Perhaps the most pertinent State Court decision is *Tennant* v. *Dunn*, 130 Tex. 285, 110 S.W. 2d 53, analyzed and extensively quoted from in the opinions below. That case involved a carved out oil payment and the highest Court of Texas expressly held that:

> "*It is not a promise to pay money. It is not a contract for the sale and delivery of oil, as personalty after production*, but it undertakes to invest the assignee, and we think it does invest her, presently with a right or interest in what the assignor owned. * * * A part of the lessee's right or interest is assigned, not a fractional interest in the entire leasehold estate but the absolute right, without charges for production or operation, to a fractional part of the oil as and when it is produced from a well on the leased land.

[11] In addition to the five opinions below see particularly *Ortiz Oil Company* v. *Commissioner*, 102 F. 2d 508, cert. denied 308 U.S. 506, Appendix C, p. 138 infra; *Commissioner* v. *I. A. O'Shaughnessy, Inc.*, 124 F. 2d 33, Appendix C, p. 143 infra; *Commissioner* v. *Rowan Drilling Company*, 130 F. 2d 62, Appendix C, p. 145 infra. *Commissioner* v. *Hawn*, 231 F. 340, does not, as is clearly demonstrated by Judge Hutcheson's opinion in the O'Connor case (R. 81 et seq), conflict with any of the cases just cited.

[12] All of the cases now under review except the O'Connor case came from the Tax Court and were decided on the capital gain question in favor of the taxpayers. The same conclusion was reached by the Board of Tax Appeals in the *Ortiz Oil Company case*, 37 B.T.A. 656, and numerous other cases.

> * * * Mrs. Dunn did not become by virtue of the assignment a mining partner or a joint adventurer, *for it gave her, not merely a part of the profits of the enterprise, but an interest in land free of charges for development or operation and without obligation to share in losses.* * * * (Emphasis supplied)

The contention of the petitioners (Petitioners' brief, pp. 38-40) that the grantees of the oil payment interests involved did not make a capital investment in the oil in place and that no such investment is made unless it represents an "indispensable contribution" to oil production is wholly unsound. In the first place, the phrase "indispensable contribution" is lifted out of context from this Court's opinion in the *Southwest Exploration* case. In using it, the Court was answering the Exploration Company's argument that a depletable economic interest is not acquired by one whose investment does not represent an "indispensable contribution" to the producing operation, and this Court merely held that by granting the right to use the riparian lands their owners had made an investment and that it was under the circumstances indispensable to the Exploration Company, in that such rights had to be acquired in order to develop the property. This cannot be tortured into a holding that the consideration (the investment) paid by a purchaser for a depletable economic interest must go into the property itself in order for that purchaser to acquire the requisite depletable economic interest. Under such a doctrine any one who acquired an entire oil and gas leasehold for cash,

which the seller used for such purposes as he saw fit, and not upon the property in which he had no further interest, would not acquire a depletable economic interest. Such a doctrine is not and has never been the law as the cited cases show.

Whatever plausibility there may be in petitioners' argument that the assignments in question were of future income and not present interests in the property, were fruit not tree, is based upon a misconception of the unique character, tax wise, of oil and other mineral holdings. Certainly petitioners will not argue that an oil reserve is not property or is not capital. They will not argue that no sale of an oil reserve can produce capital gain.[13] Yet the oil reserve, because it is incapable of replacement, and has no economic value (other than for resale) except to the extent that the oil reserve is produced and made commercially available and thereby exhausted, produces a yield which when the producing operation is completed is entirely income, taxable as such, without any deductions for depletion or loss of capital other than those Congressional grace expressly permits. Thus an oil reserve is not like a tree which yields fruit from year to year leaving the tree intact and capable of producing another crop. When the oil is produced the entire property, which was previously entirely capital, becomes entirely income, leaving nothing of

[13]**The petitioners' own rulings are to the contrary. See *I.T. 3693*, Appendix B, p. 112 infra; *G.C.M. 12118*, Appendix B, p. 84 infra; *G.C.M. 22730*, Appendix B, p. 88 infra.**

the original capital investment, no matter how large it might have been, except what Congress expressly permits to be deducted from the income. This unique situation arises regardless of the precise character of ownership in the oil reserve. It is true of a fee owner who develops and produces oil from his own lands. It is true as to the landowner's royalty interest. It is true as to ordinary leasehold working interests. It is true of overriding royalties, of oil payment interests and of net profit interests. The very principle upon which petitioners rely to establish that the conveyances here under consideration were of future income is equally applicable to an assignment of any of the interests just enumerated, or any part thereof. But this argument proves too much. It is directly contrary to what everyone admits, which is that the conveyance of any of the interests enumerated or continuing undivided interests in them, save and except only the carving out and sale of an oil payment interest, are not assignments of future income but are conveyances of property which, when the other statutory requirements are met, produce long term capital gain.

Therefore we say that the oil payment conveyances here involved conveyed depletable economic interests (ownership) in the property interests from which they were carved and were not merely assignments of future income. With this established we shall proceed, first, to a consideration of the non-taxable exchange question involved only in the Fleming case, and then to a consideration of the capital gain issue which must

be decided in the Lake case, and which will be reached in the Fleming case only if this Court reverses the Court below in holding that the gain from the Fleming exchanges was not to be recognized under *Section 112 (b)(1)* Internal Revenue Code of 1939.

II.

The oil-payment interests conveyed by the Flemings and Walsh, and the lands which they received, were properties of like kind within the purview of Section 112(b)(1), Internal Revenue Code of 1939, so that no gain is to be recognized from the exchange.

The governing statute, which in substantially the same form has been in revenue legislation since 1921,[14] provides that if certain conditions are met, no gain or loss from the exchange of properties of like kind is to be recognized. The statutory provision excludes from its scope practically all intangible property, "stock in trade, or other property held primarily for sale, * * *, stocks, bonds, notes, choses in action, certificates of trust or beneficial interests or other securities or other evidences of indebtedness or interest." Except for this limitation, if "property held for productive use in trade or business or for investment," is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment, "no gain or loss shall be recognized." (Section 112(b)(1), I.R.C. of 1939, p. 73,

[14]The original non-taxable exchange provision first appeared as *Section 202(c)* of the Revenue Act of 1921.

infra.) It was stipulated that the taxpayers in the *Fleming* case held the oil properties involved, for productive use in their trade or business and not for sale (R. 162, 166), and that the ranch and urban lands received by the taxpayers in their exchanges were acquired and held for investment (R. 162, 166). Therefore, if what the taxpayers exchanged was a part of their oil holdings and was like in kind to the lands which they received, the requirements of the statute are met and the statutory mandate that no gain or loss be recognized from the exchange is clear.

It has been established under Subdivision I of this argument, pages 18 to 32, supra, that the oil payment interests conveyed by the Flemings were interests in land—real property. See also *Fleming* v. *Campbell*, 205 F. 2d 549, summarized in Appendix C, page 147 infra, as well as other cases summarized in that Appendix.

From the Regulations promulgated under the Revenue Act of 1921—when the prototype of Section 112 (b) (1), Internal Revenue Code of 1939 was adopted[18]

[18]Regulations 62, relating to the Revenue Act of 1921, provides in Article 1566: "Where property held for investment is exchanged for other property of a like kind, or where property held for productive use in trade or business is exchanged for other property of a like use * * * (no gain or loss is recognized). The words 'like kind' are defined as having reference to the nature or character of the property and not its grade or quality * * *. The fact that any real estate involved in an exchange is improved or unimproved makes no difference for such fact relates to only the grade or quality of property and not to its kind or class."

—to the present time, the Regulations have provided that the words "like kind" used in the statute have reference to the nature or character of the property and not to its grade or quality. As illustrative of this, the Regulations have provided, "The fact that any real estate involved is improved or unimproved is not material, for such fact relates only to the grade or quality of the property and not to its kind or class." A further illustration in the Regulations is that "no gain or loss is recognized if * * * (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with thirty years or more to run, for real estate, or improved real estate for unimproved real estate."

The only pertinent appellate court decisions are those of the court below. Each involved the identical or substantially the same statutory provision and the identical or substantially the same Treasury Regulation. In 1941, in *Commissioner* v. *Crichton*, 122 F. 2d 181, the court below, after expressly approving the Treasury Regulation then in force, held that mineral interests under Louisiana rural lands could be exchanged for an interest in urban property without recognition of gain.[16] In 1953, in *Fleming* v. *Campbell*, 205 F. 2d 549, the court below held that a carved-out oil payment was property like in kind to a landowner's perpetual mineral interest, so that an exchange of the two types of property came within the

[16]The *Crichton case* is more fully summarized in Appendix C, p. 142 infra. These regulations were also expressly approved in *Century Electric Co.* v. *Com.* 192 F. 2d. 155, cert. den. 342 U.S. 954.

statutory non-recognition provision under consideration. In this case, the court also held that the provision in the Regulation with respect to "a leasehold of a fee with thirty years or more to run" plainly referred to the ordinary leasehold and had no application to an oil, gas or mining lease.[17]

It should be noted that *Fleming* v. *Campbell, supra,* was decided before the Internal Revenue Code of 1954 was enacted, and that Congress reenacted the statute in substantially identical terms, and again the provisions of the earlier Treasury Regulations were re-adopted without material change.

Further supporting the non-taxable-exchange theory are two rulings of the Internal Revenue Service. The first, I.T. 4093, C.B. 1952-2, page 130, held that a producing oil lease which could extend until the exhaustion of the deposit could be exchanged for ranch lands without the recognition of gain or loss to either party.[18] This opinion not only cites the *Crichton* case but states that, "It is the position of the Bureau that the interest of a lessee in a producing oil lease extending until the exhaustion of the deposit constitutes an interest in real property for federal tax purposes (see I.T. 3693, C.B. 1944, p. 272; and *Palmer* v. *Bender*, 287 U.S. 551* * *)."

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[17] *Fleming* v. *Campbell, supra,* is more fully summarized and quoted from in Appendix C, p. 147 infra.

[18] *I.T. 4093* is reproduced in full in Appendix B, p. 127 et seq. infra.

In Internal Revenue Ruling 55-749, 1955 C.B. 2, p. 295, it was held that a perpetual water right (a right to obtain water for irrigation purposes) was property like in kind to a fee simple interest in land, and could be exchanged without recognition of gain under Section 1031 (a), Internal Revenue Code of 1954, which is the reenactment of the Section 112(b)(1), Internal Revenue Code of 1939 here under consideration.[19]

In opposition to the views above expressed, the Commissioner argues, first, that the conveyances were assignments of future income, which is the same argument advanced in opposition to the capital-gain question in all of the five cases grouped in petitioners' petition for certiorari and now being considered. This proposition has been dealt with separately under subdivision I of this argument, pages 18-32, *supra*, but some other points advanced will be considered. At page 56 of the petitioners' brief it is stated that "Actually * * * the Flemings' oil-payment assignments were merely arrangements for delayed cash payment of the purchase price of real estate plus interest thereon." As applied to the facts and the deficiency determination under review, this is a statement that by arranging for the "delayed cash payment of the purchase price of real estate" the taxpayer received ordinary depletable income. This, we believe, is the first time the

[19] *I.R.R. 55-749* is reproduced in full in Appendix B, p. 131 et seq. infra.

Treasury has ever advanced the argument that arranging to purchase real estate for delayed cash payments produced ordinary depletable income from property—or, in fact, the first time it has ever been seriously contended that any purchase produced taxable income. It would seem that although petitioners disavow the holding in *Commissioner* v. *Slagter*, 238 F. 2d 901, to the effect that the consideration received for the conveyance of a carved-out oil payment is to be treated as a loan, they are here adopting that view. Of course if that view were correct, then the Fleming taxpayers received no income when the exchanges were made, whether or not they come within Section 112(b)(1), but received income largely in future years as the oil applicable to the oil payments was produced and applied to what the petitioners term "purchase price of real estate plus interest thereon."

The *Crichton* case, *supra*, based its holding to some extent upon the nature of the properties exchanged as determined by State law, as well as upon an interpretation and approval of Treasury Regulations. I. T. 4093, *supra*, cited and approved the Crichton case in 1952. In 1955, in I.R.R. 55-749, supra, "applicable State law" was again made the criterion for determining likeness in kind. Similarity in appearance, in use or other attributes is clearly not the test of likeness in kind as used in the governing statute. This is completely demonstrated by the cited rulings as to

the likeness in kind of water rights and fee interests in land and of oil and gas leaseholds and ranch lands.

The statutory provision is not to be construed as an exemption statute. Under the related "basis" section of the law,[20] the basis of the property exchanged becomes the basis of the property received in exchange, so that in accordance with a congressional purpose which has not been departed from since 1921, and which was reaffirmed when the Internal Revenue Code of 1954 was adopted, the taxation of income is merely deferred until realized from the asset received in exchange.

The types of property which are excepted from the application of Section 112(b)(1) are "stock in trade or other property held primarily for sale * * * stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest". With these exceptions any property "held for productive use in trade or business or for investment" can be exchanged for other property to be held for productive use in trade or business or for investment, provided only that the exchanged properties are "of like kind", that is, of the same nature or character. Clearly the oil payment interests which the Flemings exchanged do not come within any of the excepting provisions just quoted. Such oil payments are not stock in trade, were not held primarily for sale, are not stocks, bonds or any

[20] Section 113(a)(6) I.R.C. of 1939.

other specified items of property. It follows that such oil payments, since they are not mere assignments of future income (as has been demonstrated elsewhere herein), can be exchanged without the recognition of gain for some other type of property, if the property received is held for productive use in trade or business or for investment. Breeding cattle, trucks or buses, trade fixtures, factory machinery not affixed so as to become part of real estate are all types of property which can be acquired and held for productive use in trade or business. Are they more like in kind to oil payment interests than real estate? Would it more nearly accord with the petitioners' view as to how the statute is to be applied if the Flemings had received properties of any of the types just mentioned solely in consideration for their oil payments? It would seem that the petitioners must choose one or the other horn of this dilemma, or must take the wholly insupportable position that an oil payment is neither "fish nor fowl" and cannot be exchanged either for real estate or for chattels under Section 112(b)(1) of the 1939 Code. This is a wholly indefensible position.

It is therefore submitted that the Fleming case should be disposed of by holding that Section 112(b)(1) of the 1939 Code applies, and that the Fleming taxpayers received no recognizable gain from their exchanges.

III.

For many years prior to the determination of the deficiencies involved in both the Fleming and Lake cases, the Treasury's administrative practice was to treat the sale of a carved-out oil payment as productive of long-term capital gain if the other statutory requirements of such treatment were present. This position had received judicial and congressional approval and had become so crystallized into the law that a change should not be permitted—particularly when the change is applied retroactively.

Since the first statutory provision dealing with capital-gain taxation was enacted in 1921, down through and including the Internal Revenue Code of 1954, there has been no change in the "capital-gain" sections of the various Revenue Acts and Codes directly pertinent to this proceeding. If the sale of a carved-out oil payment would have produced long-term capital gain under the Revenue Act of 1921, there is no statutory reason why such a transaction would not produce long-term capital gain under the Internal Revenue Code of 1939 or that of 1954, or under any of the numerous Revenue Acts enacted between 1921 and the 1939 Code.

Until 1946, the practice of the Commissioner was to treat the sale of a carved-out oil payment (if statutory requirements as to holding period, etc., had been met) as productive of long-term capital gain. In

1946, G.C.M. 24849 was published, in C.B. 1946-1, at page 66. That opinion (reproduced in full in Appendix B hereto, page 117, *infra*) is limited in its application to what is there termed "short-lived in-oil-payment rights," which the opinion states "ordinarily pay out and expire within one or two years," and the ruling, while expressing no opinion as to the status of oil-payment rights extending over a substantial portion of the life of the depletable economic interests from which such rights are carved, went on to hold that the assignment and sale of a short-lived oil payment produced ordinary depletable income. That this was a complete reversal of the previous position and practice of the Commissioner is conclusively shown by I.T. 3895, C.B. 1948-1, page 39, ruling that G.C.M. 24849 would not be given retroactive application but would be applied "only to such assignments made on or after April 1, 1946." It was not until 1950 that the Commissioner entirely departed from his earlier practices by ruling, in I.T. 4003, C.B. 1950-1, page 10, in substance that there was no legal or economic basis for distinguishing between long-lived and short-lived oil payments, and that the carving out and sale of an oil-payment interest which extended over a period of less than the life of the depletable property interest from which it was carved produced ordinary depletable income.[21]

[21]Both *I.T. 3895* and *I.T. 4003* are reproduced in full in Appendix B, hereto, p. 124 and p. 125, et seq., infra.

Prior to the promulgation of G.C.M. 24849, it had been expressly held, at the instance of the Commissioner, that the carving out and sale of an oil payment which paid out in approximately four years was a sale of an interest in the leaseholds, so that the seller was not entitled to an allowance of depletion against the consideration received but could merely deduct therefrom an aliquot portion of cost as in the case of the sale of any other type of property; that the transaction constituted "a sale of oil in place"; and that the purchaser of the oil payment "simply acquired an interest in oil in place. The right to share in the oil produced constituted an economic interest in the properties to the amount agreed upon. *Palmer* v. *Bender*, 287 U.S. 551." In the same case it was held that a purchaser of the carved-out-oil-payment interest was entitled to depletion as oil applicable to the oil payment was produced. *Ortiz Oil Company* v. *Commissioner*, 102 F. 2d 508 (C.A., March 14, 1939), affirming 37 B.T.A. 656, cert. den. 308 U.S. 566.[22] Likewise prior to the promulgation of G.C.M. 24849, there had been a rather full development by judicial decision of the nature of oil-payment interests, the right of the owner of such an interest to depletion, and related tax problems. Many of these cases are

[22]See Appendix C, p. 138 infra for a fuller treatment of the Ortiz case. Capital gain was not allowed Ortiz Oil Company in that case because under the applicable statute no corporation was allowed capital gain benefits. Section 101 Revenue Act of 1932. Even if the taxpayer had not been a corporation, the facts show that the oil leases had not been held for the requisite period of time for capital gain treatment.

collated elsewhere in this brief and will not be further discussed here, but all are directly opposed to some or all of the views expressed in G.C.M. 24849 or the later I.T. 4003.[23]

We submit that the administrative practices existing prior to 1946, judicially approved—and at least inferentially approved by Congress through repeated reenactments of the pertinent statutory provision—had become crystallized as a part of the law, placing it beyond the power of the Commissioner, without congressional sanction, to change the rule, prospectively or retroactively. Sufficient authority for this is found in this Court's recent holding in *United States* v. *Leslie Salt Company*, 350 U.S. 383, decided March 5, 1956. That case involved an attempt on the part of the Commissioner—emboldened by his victory in *General Motors Acceptance Corporation* v. *Higgins*, 161 F. 2d 593—to extend, by ruling, the section of the tax law levying a stamp tax upon bonds, debentures, certificates of indebtedness and other corporate securities, to promissory notes issued by Leslie Salt Company and privately placed with two insurance companies. It was argued in much the same vein as the argument advanced in the petition for certiorari to the effect that the Treasury was suffering from the

[23]See the summary of cases in Appendix C, pages 135 to 152, infra, and the discussion under the first subdivision of this argument, pages 18 to 32 supra.

sale of carved-out oil payments,[*] that, if the currently employed method of privately placing large corporate notes with investors had been brought to the attention of Congress when the law was under consideration, transactions like that of Leslie Salt Company would have been included in the statutory scope.

In denying the Commissioner his assumed legislative prerogative, this Court quoted from *Norwegian Nitrogen Products Company* v. *United States*, 288 U.S. 294, 315, as follows:

> "* * * adminstrative practice, consistent and generally unchallenged, will not be overturned except for very cogent reasons if the scope of the command is indefinite and doubtful. United States v. Moore, 95 U.S. 760, 763; 24 L.Ed. 588; Logan v. Davis, 233 U.S. 613, 627, 34 S.Ct. 685, 58 L.Ed. 1121; Brewster v. Gage, 280 U.S. 327, 336, 50 S.Ct. 115, 74 L.Ed. 457; Fawcus Machine Co. v. United States, 282 U.S. 375, 51 S.Ct. 144, 75 L.Ed. 397; Interstate Commerce Comm. v. New York, N.H. & H.R. Co., 287 U.S. 178, 53

[*] "We believe this argument is factually unsound as well as legally immaterial. The petitioners' theory is a two-edged sword. If correct, it would permit oil operators through the device of selling oil payments—short-lived or long-lived—to concentrate ordinary depletable income from the property in the year most advantageous to them, and by avoiding the impact of the limitation on percentage depletion to not more than 50% of the net income from the property, calculated without an allowance for depletion, materially increase their statutory percentage depletion allowances which, as petitioners' point out in their brief, are not limited to cost or other basis in the property.

> S.Ct. 106, 77 L.Ed. 248 * * *. The practice has peculiar weight when it involves a contemporaneous construction of a statute by the men charged with the responsibility of setting its machinery in motion, of making the parts work efficiently and smoothly while they are yet untried and new."

and then said:

> "Against the Treasury's prior longstanding and consistent administrative interpretation its more recent *ad hoc* contention as to how the statute should be construed cannot stand. Moreover, that original interpretation has had both express and implied congressional acquiescence, through the 1918 amendment to the statute (76 S.Ct. 421), which has ever since continued in effect, and through Congress having let the administrative interpretation remain undisturbed for so many years. See Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 53, 76 S.Ct. 20, 24; Norwegian Nitrogen Products Co. v. United States, supra, 288 U.S. at page 313, 53 S.Ct. at page 357."

It should be noted that the *General Motors Acceptance Corporation* case was decided in 1947, while the Leslie Salt Company transaction occurred in 1949, but this fact was not allowed to strengthen the Commissioner's power to change his position.

If the power to change position prospectively when the change is supported to some extent by a court decision is to be denied to the Commissioner, as was done

in the Leslie Salt Company case, there is much more reason to deny any retroactive effect to the change in position, particularly when it is not supported by a single court decision or any congressional action. In 1948 when the Fleming-Cline exchange was made, and in 1949 when the Walsh-Cross exchange was made, neither of which involved short-lived oil payments as the term was used in G.C.M. 24849, there was not a single ruling, judicial decision, or congressional action or inaction, which indicated to any taxpayer that there would be a change in the treatment of proceeds received for the sale of long-lived oil payments.[25] So, as far as the *Fleming* case is concerned, in addition to the plain pronouncement in the *Leslie Salt Company* case denying the right to change prospectively the rules applicable to the *Lake* case, we have the added vice of retroactivity.

Therefore, we earnestly urge that the *Leslie Salt Company* case is sufficient and compelling authority for the affirmance of the holdings below on the capital-gain issue, and that the Commissioner should be told that if he was dissatisfied with his earlier long-continued practice he should have sought legislative relief.

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[25] As petitioners point out in their brief (pp. 11-12) the Fleming oil payments had lives varying from five years and eight months to "ten to twelve years". The Walsh oil payment had an estimated life of three and one-half years.

IV.

Taxpayers' oil-payment conveyances were sales (or exchanges) of fractional interests in the taxpayers' leasehold (or mineral) interests, conveying for a consideration depletable economic interests (ownership) and fully meeting the statutory requirements for capital-gain treatment.

This Court and other Courts have held that contractual provisions which under ordinary tests would not be classified as formal reservations or conveyances were sufficient to retain or to convey depletable economic interests (ownership) in oil reserves. *Thomas* v. *Perkins*, 301 U.S. 655; *Commissioner* v. *Southwest Exploration Company*, 350 U.S. 308, and several of the cases summarized in Appendix C hereto, infra pp. 135 to 152, clearly establish this. In the cases now under consideration we have no lack of formality. Each instrument in the familiar language of conveyances purported to bargain, sell, assign and convey interests in the oil and gas leases (R. 9, 168, 171, 173, 175, 178). Clearly, to the extent it is legally possible so to do, these conveyances accomplished sales of present interests in the taxpayers' respective properties. That it is possible to convey such present interests is fully established by the decisions of this Court, of the highest Court of Texas, by many Circuit Court and Tax Court decisions, and, indeed, by the Treasury's own rulings, all of which have been heretofore cited and discussed.

That the transactions meet all of the literal requirements for long-term capital-gain treatment laid down in *Section 117 I.R.C.* of 1939 is equally clear. It was stipulated that the taxpayers had held their respective properties for productive use in their trades and businesses of producing oil, and not for sale, for the time required by the statute, and, indeed, for much longer than the required time; that these holdings were property and that the interests conveyed were parts thereof is equally clear. That whether the taxpayers' holdings and the interests conveyed be considered "real property used in * * * trade or business" is immaterial in determining the applicability of the capital gain provisions in these cases has been heretofore demonstrated. (Footnote 5, p. 19 supra). By stipulation and undisputed facts these interests are not inventoriable property, stock in trade or property held primarily for sale to customers, and, of course, the statutory exceptions as to copyrights, etc., and governmental obligations issued at a discount have no possible application. These exhaust the statutory exception to the general definition of "capital assets", which by the statute means "property held by the taxpayer (whether or not connected with his trade or business)" with the exclusions just specified.

These transactions come as clearly within the spirit and purpose of Section 117, I.R.C. of 1939 as they come within its letter. The capital gain provisions of the 1939 Code, as well as those of the Internal Revenue Code of 1954, are a continuation of those first enacted

in the Revenue Act of 1921 and there made applicable only to non-corporate taxpayers. The 1921 provisions did not, as more recent statutory provisions do, limit the deduction for capital losses except to the extent that they offset capital gains. The original holding period required was two years. It is clear that the 1921 provisions were enacted for a double purpose, first, to avoid the injustice which would result if taxpayers were taxed at ordinary income tax rates on the gain realized from holdings where the gain represented an enhancement in value occurring over a period of years; and, second, to encourage such realizations and thereby produce revenue which would not be available if high surtax rates discouraged the realization of such enhancements. At an early date this Court said, with respect to these provisions:

> "The exemption of income devoted to charity and the reduction of the rate of tax on capital gains were liberalizations of the law in the taxpayer's favor, were begotten from motives of public policy, and are not to be narrowly construed." *Helvering* v. *Bliss*, 293 U.S. 144, 151.

Between the adoption of the Revenue Act of 1921 and the present time, Congress made many changes in the statutory provisions relative to the taxation of capital gains. Among those pertinent here are the following: There were changes in the requisite holding period. At one time the early and present flat rate of taxation was done away with and different percentages of gain, depending upon holding period, were includible as ordinary income. Thus under one Act

capital gain on property held for less than one year was included in ordinary income in its entirety, while, if the property had been held for ten years or more, only thirty per cent was included. Later the flat rate was reinstated and has been applicable at least since the adoption of the Internal Revenue Code of 1939. With the increase in the rate of taxation on corporate income, capital gains realized by corporations were taxed substantially as were capital gains realized by non-corporate taxpayers. Distinctions between long-term and short-term capital-gain were introduced and provisions sharply limiting the deductibility of both short-term and long-term capital losses were adopted. As questions arose as to whether certain transaction did or did not produce capital gain, Congress by express statutory provision made it clear that it was intended that capital gain treatment be applied in these disputed areas. Examples may be found in the treatment accorded gain from the sale of growing crops, timber, livestock held for breeding purposes, etc.[26] Most important, Congress reduced the requisite holding period for both long-term capital gains and losses to six months.[27]

When Congress adopted a six month holding period as the standard for determining whether long-term capital gain or loss treatment was to be applied, it clearly departed from one of the purposes which im-

[26]Sec. 117(j)(1), (3)(k) I.R.C. of 1939.

1958 Standard Federal Tax Service (C.C.H.) Vol. 4, pp. 47,005-6.

[27]Sec. 117(a)(4) and (5) I.R.C. of 1939.

pelled the adoption of the capital gain provisions first contained in the Revenue Act of 1921. When, for example, the gain from the sale of corporate stock owned for six months and one day is taxed at exactly the same rate as a similar amount of gain realized from the sale of stock held for ten or twenty years, it is impossible to say that the statutory provision was enacted to prevent the injustice of taxing, at progressive rates, realized enhancement in value occuring over a long period of years. This, taken in connection with the provisions limiting the deductibility of capital losses, forces the conclusion that at least since 1939 the Congressional purpose was to protect the revenue by limiting the deduction of losses from the sales of capital assets, and to increase the revenue by encouraging sales and realization of capital gain, which sales would be most effectively discouraged if resulting gains were taxed at progressive rates.

The express terms of *Section 117*, I.R.C. of 1939 show the Congressional purpose, and, when these are applied with reasonable regard for the ordinary meaning of the terms used, this Congressional purpose will be accomplished. Congress could scarcely have used a broader term than the word "property". That it was to be broadly applied is emphasized by the parenthetical clause immediately following—"whether or not connected with his trade or business." Realization of gain "by sale or exchange" is required. This excludes income from services, rents, interests, dividends, etc. Income from trading, merchandising,

manufacturing and related activities is excluded by the excepting provisions "stock in trade, inventoriable property, property held primarily for sale to customers", as is income from sales of certain types of property—copyrights, certain governmental obligations, etc., heretofore discussed.

Considered together all of these factors force the conclusion that Congress intended to include within the capital gain and loss provisions of the 1939 Code all sales or exchanges of property, except those specifically excepted, and those which arose and recurred in the ordinary day to day business of a taxpayer. So we submit that these taxpayers' conveyances give rise to long-term capital gain because they come within the spirit as well as the letter of Section 117 of the Internal Revenue Code of 1939.

To meet this petitioners rely primarily upon *Watson* v. *Commissioner*, 345 U.S. 544, and *Corn Products Company* v. *Commissioner*, 350 U.S. 46. The Watson case dealt with the sale of an interest in an orchard and the rapidly maturing crop on the trees, which crop was the principal element in value. The holding of this Court in the *Watson* case was that the fact that, by State law, the growing crop was classified as real estate did not prevent it from being property held primarily for sale to customers within the except-

ing provision of the capital gain section.[28] This situation might be compared to the sale by a merchant of the building occupied by his store, to trade fixtures and his stock of merchandise. Any gain realized from the sale of the merchandise would of course be gain from property held primarily for sale to customers and, no doubt, would be inventoriable property. The fact that the other interests sold (real estate and fixtures) might qualify for capital gain treatment would not prevent the express statutory provision as to property held primarily for sale to customers from being applied. Likewise, Mrs. Watson was holding her fruit crop—but not the trees—for sale to customers in the ordinary course of her business. There is nothing in the statute which makes any item of property any less property held for sale to customers because it is actually real estate or is classified by State law as real estate. Real estate can be held for sale to customers as is evidenced by the almost innumerable decisions dealing with the subdivision and sale of real estate.

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[28] In the *Watson* case this Court was careful to say, 345 U.S. 544-552: "We do not have here the situation which arises from the sale of land, including coal or other mineral wealth not separated from its natural state and not in the course of annual growth leading to a seasonal separation. See Butler Consolidated Coal Co. v. Commissioner, 6 T.C. 183. The instant case also is distinguishable from that of growing timber which is not in itself an annual or short-term product. See Carroll v. Commissioner, 70 F. 2d 806; Camp Manufacturing Co. v. Commissioner, 3 T.C. 467."

Nor does the holding of this Court in the *Corn Products Company* case *supra*, justify the denial of capital-gain treatment to these taxpayers. As this Court's opinion in that case emphasizes, the transactions in corn futures there under consideration were recurring, day to day, transactions designed to reduce or stabilize the cost to Corn Products of the raw materials used in its manufacturing business, entered into for that express purpose and effectively accomplishing that result. If we assume—and we think such assumption is directly contrary to the facts—that by this Court's statement in the *Corn Products Company* case that the capital gain provisions are to be narrowly applied so as to effectuate the Congressional policy of taxing at ordinary income rates the profits "arising from the every day operation of a business" this Court overruled its statement in *Helvering* v. *Bliss*, *supra*, that the capital-gain section was not to be "narrowly construed", it avails petitioners nothing. For this Court went on to say that the capital-gain section should not be applied to profits "arising from the every day operation of a business" and capital-gain treatment should be limited "to transactions in property which are not the normal source of business income." The taxpayers' transactions now under consideration by the Court were not, as the stipulation and admitted facts clearly show, every day operations and were not the "normal source of business income" of these taxpayers. They were isolated sales by which these taxpayers realized enhancement in value of a portion of their property interests by

separate, single and isolated transactions, and are therefore within the spirit and the letter of Section 117 of the Internal Revenue Code of 1939.

V.

Petitioners' actions and theories necessarily result in excessive depletion allowances forbidden both by the statute and the express holdings of this Court.

It has been established that those to whom the taxpayers conveyed the oil payment interests in their respective properties thereby acquired depletable economic interests in such properties. Such grantees made investments which entitled them to a share of the oil to be produced from the respective properties when, as, and if, but only when, as, and if, such oil was produced, and gave them no right to look to any source other than oil when, as, and if produced, for the recovery of their investment. That such an interest in an oil property is a depletable economic interest is conclusively established by the decisions of this Court and other Courts which have been heretofore cited and discussed.[29]

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[29]See argument pp. 20 to 22 supra, and cases there cited. That the grantees in the several oil payment conveyances acquired depletable economic interests is conclusively established by *Palmer* v. *Bender*, 287 U.S. 551; *Thomas* v. *Perkins*, 301 U.S. 655, and other cases by this Court down to and including, *Commissioner* v. *Southwest Exploration Company*, 350 U.S. 308.

But the Commissioner, in determining the deficiencies against the several taxpayers here under consideration, allowed to each taxpayer depletion with respect to the consideration received for the oil payment interest conveyed. This is an essential part of the petitioners' theory of the case, which in essence is that the conveyances were not conveyances of present interest in property—capital assets—but assignments of future income from the future production of the property.

The holdings of this Court further show that depletion is allowable to a taxpayer only with respect to the oil which comes from his economic interest, and not with respect to the oil which comes from the interest of another, and, contrawise, that no taxpayer can be denied depletion on what is actually his share of the production.[39]

Thus, if the Commissioner's determinations with respect to depletion are correct, we would have this result: If a carved out oil payment was to come from one-fourth of future production, the assignor of the carved out oil payment would be allowed depletion on the consideration which he received for the oil payment upon the theory that it was a realization of the oil to be produced in the future applicable to this interest. Then, when the oil was actually produced and reported as the income of the oil payment holder, as

[39] *Helvering* v. *Twin Bell Oil Syndicate*, 293 U.S. 312. Treasury Regulations have consistently been to the same effect. See Sec. 39.23(m)-1-(b) of Treasury Regulations 118, Appendix A, infra.

it must be under the cited decisions of this Court and other Courts, the oil payment holder would be granted a depletion allowance with respect to the self-same oil. Thus depletion would be allowed with respect to more than 100% of the oil produced. This is expressly forbidden by the holding of this Court in *Helvering* v. *Twin Bell Oil Syndicate*, 293 U.S. 312, where this Court said that the depletion section "must be read in the light of the requirement of apportionment of a single depletion allowance"; that "gross income from the property" in the depletion section "points only to gross income from oil and gas"; and that the result contended for by the taxpayer in that case "would be a total allowance of 27-1/2 per cent of five-fourths of the total production" and not permissable.

The vice of the petitioners' position is most effectively and irrefutably stated by Judge Hutcheson in his opinion in the Lake case (R. 26) where he stated:

> "This brings us at last to what in our opinion is the crowning inconsistency of the commissioner's whole argument. This is that the government, through the commissioner, has the right and power to remake or reinterpret their contract for the parties, so that, though according to the teachings of all the cases, the assignee and not the assignor of a mineral interest, under instruments like those here, is entitled to take depletion on it, the commissioner can by his intervention deprive the assignee of his contract right to depletion in the years following and require the assignor to

> take it all in the year of the sale before the right to it has arisen. Of course, if the instrument transferred an economic interest in the oil, the commissioner cannot do this."

It was perhaps in an effort to meet this argument that petitioners' brief stated (Footnote 17 page 37)—

> "It should be noted that, even if the assignments did convey an economic interest in the oil in place, the assignees would be entitled to depletion only on the excess of the oil payments over the amount paid for the assignments."

This is an obviously incorrect statement. It does not accord with the present or past tax practices of the Commissioner. We assume that it was an inadvertent error and, as heretofore stated, it has been called to the attention of petitioners' counsel, and will no doubt be corrected. Whether or not this is done, it is obvious that such a treatment would itself fly into the face of the *Twin Bell Oil Syndicate* case and the express provisions of the statute. One holding an economic interest in an oil property is entitled to an allowance for depletion based either upon cost or calculated at a percentage of income therefrom, but he cannot take both for this, too, would be a double deduction.

Since the petitioners' position canont be correct unless the taxpayers are allowed depletion as he allowed it to them, and since such an allowance is expressly forbidden by the statute and the decisions of this

Court, which require that the total allowance as to the share of the oil covered by the oil payment conveyance must go to the assignee of that conveyance, this is further and conclusive proof that the petitioners' whole position is unsound.

VI.

Admittedly correct and long continued practices of the Treasury in closely related situations further demonstrate the unsoundness of petitioners' theory here.

The fallacy in the petitioners' position can be clearly demonstrated by a consideration of other admittedly correct tax practices with respect to oil transactions. The ordinary oil and gas lease entitles the lessee to seven-eighths of all oil and gas produced and places upon him the burden of operating and developing the property at his own cost and risk. Assume that Lessee A in such a lease sells to Investor B an interest in his leasehold entitling B to 1/16th of all oil and gas produced for the life of the property, with a covenant protecting B from all liability for costs of developing and operating. This would be the carving out of an unlimited overiding royalty interest, and would leave A with 13/16ths working interest. Then assume that A conveys his leasehold interest subject to the previously conveyed overriding royalty, to Assignee C for a cash consideration, and in that assignment retains an oil payment to come from 3/16ths of the oil produced and to continue until oil of the value of $100,000

has been received by A, whereupon it is to terminate. Then Assignee C conveys to Investor D a limited overriding royalty or oil payment interest which entitles D to receive 3/16ths of the oil which would otherwise go to C until D has received oil of the value of $100,000, whereupon his interest is to terminate. Let it further be assumed that when each of these transactions took place, the seller or assignor had held the specified interest in the property for more than six months, and that his situation otherwise met the requirements for long-term capital-gain treatment.

Each of the transactions above outlined is an ordinary, commonplace one, and such transactions continuously occur and reoccur in the oil business.

From the beginning, the Treasury has treated and now treats the sale of the unlimited overriding royalty by A to B as productive long-term capital gain to A.[31] If A had a cost in his oil reserve, as distinguished from a cost in equipment, he could allocate a portion thereof against the proceeds which he received for the overriding royalty and the balance would constitute his long-term capital gain. Likewise, when A sold the remainder of his leasehold interest to C, reserving an oil payment, it would be held for tax purposes that he had sold a part of his leasehold and had retained a part represented by his reserved

[31]G.C.M. 22730, Appendix B, p. 88 infra; G.C.M. 22849, Appendix B, p. 117 infra.

oil payment.[32] Here again, he would allocate leasehold costs between the interest sold and the interest retained and treat the difference between the amount received from C and the allocated portion of leasehold cost as long-term capital gain. If A continued to hold his reserved oil payment, amounts received therefrom would be ordinary depletable income and those amounts would not be includable as a part of C's income.[33] If A sold his retained oil payment, or an interest therein continuing for its life, at all times and now, that would be treated as an ordinary sale producing long-term capital gain.[34] Until the change of position dealt with in the previous subdivision of this argument, pages 40 to 46, *supra*, the sale by C of a carved-out oil payment to D would have been productive of long-term capital gain, as would have been the sale by A of an interest in his retained oil payment which did not continue for its entire duration.

Not only, as we have heretofore seen, was the change in position dealt with in the previous subdivision of this argument without judicial sanction or congres-

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[32] *Thomas* v. *Perkins*, 301 U.S. 655; *Fleming* v. *Commissioner*, 82 F. 2d 324; *Ortiz Oil Company* v. *Commissioner*, 102 F. 2d 508; Appendix C, p. 138 infra; G.C.M. 22730, Appendix B, p. 88 infra.

[33] See authorities cited in footnote 32; supra.

[34] The very rulings which purport to deny capital gain treatment to the carving out and sale of an oil payment admit this. See G.C.M. 22849, Appendix B, p. 117 infra; I.T. 4003, Appendix B, p. 125 infra.

sional approval; but upon the assignment-of-future-income question now under consideration, we confidently assert that if an assignment of an oil-payment interest freed from cost, which will expire before the property is exhausted and when oil of a certain value has been received, is an assignment of future income and not a conveyance of an interest in the property, then an assignment of an unlimited overriding royalty which will continue for the life of the property regardless of the amount realized therefrom, and which is equally free of costs and expenses, is even more an assignment of future income as distinguished from a conveyance of an interest in the property.

Reverting to the illustration: After A assigned his oil and gas lease and reserved only an oil-payment interest, he had exactly the same rights therein that D subsequently acquired when an oil payment was carved out by C and assigned to him. If the one is future income, this is equally true of the other. But the Treasury would permit A to sell his retained oil payment and treat the proceeds as capital gain, while denying the corresponding treatment to C who sold the identical interest. Equally strange is the fact that if D, after owning the carved-out payment for six months, had sold his remaining interest, he, too, would have been under Treasury practices, entitled to capital-gain treatment with respect to the proceeds of the sale.

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*See Subdivision III of the argument, pp. 40 to 46 supra.

We believe that enough has been said with respect to the illustrative situations to establish conclusively that petitioners must admit that the distinctions which they presently urge upon this Court are wholly illogical and arbitrary, or that the tax treatment which over a long period of years they have accorded types of transaction other than the carving-out and sale of oil payments has been wholly erroneous.

VII.

Petitioners' brief is premised on many unsound statements and assumptions.

Not only is much of petitions' argument premised on the incorrect assumption that an oil reserve *in situ* is a fruit-producing tree, so that fruit can be recurrently gathered with the tree remaining intact and capable of producing another crop; but it is based upon many other unsound statements and assumptions with which, in closing, we shall deal briefly.

The "increase in the value of property in which the taxpayer had a capital investment" which petitioners consider essential to capital gain treatment (Pets' brief, p. 27) is present in these cases. Clearly, taxpayers had a capital investment in their properties, otherwise they would not have been allowed depletion on any income therefrom. Just as clearly, there had been an enhancement in value; otherwise the conveyances would have produced no gain.

Against petitioners' contention that there was not a sale or exchange (Brief p. 28) is the stipulation that the Fleming transactions were exchanges (R. 161, 166).

Rhodes' Estate v. *Commissioner of Internal Revenue*, 131 F. 2d 513, where the right to receive a declared dividend was assigned, but complete ownership of the stock retained, is typical of the cases cited by petitioners at page 29 of their brief. There was a true assignment of fruit, with a rentention of the tree. How different would have been the result had some of the shares with the right to the unpaid dividend thereon been sold! That is the applicable analogy.

There is no difference, essential here, between an oil-payment interest and a working or royalty interest, as petitioners incorrectly assume (Brief p. 33). The fact that a working-interest is burdened with expense and costs from which the oil payment holder is protected by the terms of his conveyance does not downgrade the oil payment interest. Even this difference is not present when the oil payment comes from a royalty interest. If a retained oil payment is a part of the interest from which it is retained, a carved-out oil-payment is necssarily a part of the interest from which it is carved.

If a carved-out oil-payment merely assigns a contractual right "to receive future proceeds from the

sale of oil" (Pets' brief p. 33) how does this differ from the assignment of an unlimited overriding royalty, which conveys exactly the same rights and which admittedly produces capital gain.

Taxpayers' conveyances were assignments of "capital investment property" (Pets' brief p. 34). Their "capital investment property" was oil *in situ*. Assume that, before an oil payment assignment, a taxpayer's oil reserve was 100,000 barrels and 10,000 barrels were required to discharge the oil payment. After such an oil payment assignment, assignor's ownership would be reduced to 90,000 barrels. The oil payment owner became the true, present owner of the other 10,000 barrels—with all attendant risks and benefits.

That the oil-payment intersts were conveyed for considerations equal to their market value (See petitioners' brief pp. 34-36) reinforces, rather than weakens, taxpayers' contention that the conveyances were bona fide sales or exchanges of property. Petitioners here come very close to espousing the *Slagter* doctrine, which they elsewhere disavow, when they argue that the Flemings "simply used portions of their future oil proceeds to purchase real estate, paying interest on the unpaid portion of the purchase price." "Oil proceeds" are cash; the purchase of real estate for deferred cash payments is never an income producing transaction. Under the same theory, the oil proceeds would be income to the Flemings when the oil was produced, largely in years not before the

Court. This is the *Slagter* doctrine. Its application here would require that substantially all of the tax claims asserted against the Flemings be expunged. Petitioners' argument as to the effect of the Lake transaction (Pets' brief p. 34) has substantially the same error, and, since the effective date of the Lake conveyance was January 1, 1951, the adoption of petitioners' theory would wipe out all taxes asserted against P. G. Lake, Inc. for 1950, the only year before the Court.

Taxpayers' theory will not, as petitioners seem to fear, permit oil producers "to transmute ordinary income into capital gain at will" (Pets' brief p. 36). A continued practice of carving out and selling oil payments, just as a continued practice of selling leases, royalties or any other property would make the practitioner a dealer, and all his resulting gains ordinary income.

Petitioners' argument at pages 38-40 of their brief that the taxpayers' grantees did not make a capital investment when they acquired what is there admitted to be economic interests is directly in the face of the facts and law. The value of the consideration given for the economic interest (property) is the investment therein, just as the purchase price paid for a share of stock is the purchaser's investment therein. Nor need the investment be an "indispensable contribution" to oil production. Otherwise, the purchase for cash of all of an operator's interest in an oil property would

not be an investment in the oil property, for the seller will use the money as he sees fit and will make no contribution to the producing operation in which he has no further interest. The phrase "indispensable contribution" was lifted entirely out of context from this Court's opinion in the *Southwest Exploration* case, 350 U.S. 308.

The depletion deduction is not the only means of recovering a capital investment in an oil property (See pets' brief p. 41). Where the gain is from a sale, rather than from the producing operation, investment is recovered by substracting basis from selling price to calculate taxable gain, just as is true as to sales of other properties. *United States* v. *Ludey*, 274 U.S. 295; *Ortiz Oil Company* v. *Commissioner*, 102 F. 2d 508.

Petitioners misconceive the scope and effect of *Burnet* v. *Harmel*, 287 U.S. 103. In that case, the Court held that the granting of an oil and gas lease by a landowner did not give the landowner the right to treat the cash bonus (advance royalty) received by him as capital gain, for the leasing transaction was not a sale within the capital gain section, even though so classified by local law. It does not stand for the distinction based on the alleged creation of different types of interests which petitioners seek to draw therefrom. If the Treasury thought so, it could not treat the sale of an overriding carved-out royalty as productive of

capital gain (as it does) for, by the same token, the interests are of different types.

The alleged unsubstantiality of the oil payment interests conveyed by these taxpayers, which petitioners seek to establish at pages 48-54 of their brief, is not present. Clearly, substantiality is not to be determined by size or value. The sale of one share of stock by the largest stockholder in the largest corporation in the United States, or the sale of one acre of land by the largest landowner, can qualify for capital gain treatment. The possible life, or economic duration, of the property sold is not a criterion by which the applicability of the capital gain provisions is to be determinated. Otherwise, if one sold an ordinary corporate bond maturing in a few years, it would not be the sale of a capital asset. As the Court below pointed out in distinguishing our cases from *Commissioner* v. *Hawn*, 231 F. 2d 340, substantiality, in the determination of ownership, should be determined by ascertaining who possesses the essentials of the bundle of rights which everywhere make up true ownership.[36] Whomsoever has all of those rights has substantial rights, true ownership. Here, each oil payment grantee had all the rights incident to ownership. He could sell, mortgage or donate his interest. It would be

[36]Further it is difficult to see how the building contractor with whom Hawn dealt made the investment in Hawn's oil payment, which everyone recognizes is essential to the acquisition of a depletable economic interest (ownership) therein. If the contractor acquired no such depletable interest there could have been no sale—a requisite to capital gain.

transmitted at his death. The loss from the destruction of the property without fault would fall solely on him. It could be taken for his debt, but not for the debt of another. He could not be required to account for receipts therefrom or for any other transaction with respect thereto. That he could not directly participate in the producing operation no more lessened his ownership than would have been the case had the interest been an unlimited—rather than a limited—overriding royalty or an oil payment interest.

These factors, coupled with the length of pay-out of the oil payments conveyed by these taxpayers, render cases such as *Harrison* v. *Schaffner*, 312 U.S. 579, *Helvering* v. *Clifford*, 309 U.S. 331; *Helvering* v. *Stuart*, 317 U.S. 154, and the others cited (practically all of which involve donative assignments) so clearly inapplicable that they will not be discussed in detail. *Cf. Blair* v. *Commissioner*, 300 U.S. 5.

Petitioners' brief (p. 51) assumes that the time of pay-out of oil payments—such as those involved—can be accurately forecast. It is merely a coincidence that, for example, the estimated time of the Lake oil payment pay-out was accurate. Assuming that the quantity of oil in the reserve can be estimated with fair accuracy, two other factors are necessarily unpredictable—price and "allowable". The average price of oil in the East Texas Field—where the Lake properties were located,—has varied from the beginning of production in that field (1930) to 1956, from 56 cents

per barrel to $2.90 per barrel. For many years the "allowable" from non-marginal wells has been 20 barrels per day, but this was further limited by the number of "producing days" permitted by the Railroad Commission of Texas. The average number of permitted producing days in each year from 1937 to September, 1956, varied from 28 days per month to 15 days per month, and is now 10 days per month. With the variations in price similar to those mentioned, and similar variations in permitted "producing days", it would have been possible for the Lake payment to have extended for twenty years or more, and for some of the Fleming payments to have extended far beyond any reasonable estimate of the life of the properties to which they pertained. These inherent hazards were the sole risk of the oil-payment grantees, as to which their only protection was the "interest factor" which, of course, is not actually interest, but only a flexible measure of the amount of oil to which the oil-payment grantees were entitled.

CONCLUSION

For the reasons stated, it is respectfully submitted that this Court should hold that the exchanges involved in the Fleming case did not give rise to recognizable gain under *Section 112(b)(1)* of the Internal Revenue Code of 1939; and that both judgments below should be affirmed with respect to the capital gain issue.

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[31] Mineral Year Book published by the United States Bureau of Mines.

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APPENDIX A

Internal Revenue Code of 1939:

Sec. 23(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions,

on the basis of the trust income allocable to each.

For percentage depletion allowable under this subsection, see section 114(b), (3) and (4).

* * * *

Sec. 112—Recognition of Gain or Loss.

(b) Exchanges Solely In Kind.—

(1) Property Held For Productive Use or Investment.—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

* * * *

Sec. 114(b)(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents

or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

* * * *

Sec. 117. Capital Gains and Losses.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in sec-

tion 23 *(l)*, or real property used in his trade or business;

(C) a copyright; a literary, musical, or artistic composition; or similar property; held by—

(i) a taxpayer whose personal efforts created such property, or

(ii) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property; or

(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such

gain is taken into account in computing gross income;

* * * *

(c)(2) *Other taxpayers.*—If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12 (or, in the case of certain tax-exempt trusts, in lieu of the tax imposed by section 421), a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

(A) A partial tax shall first be computed upon the net income reduced by an amount equal to 50 per centum of such excess, at the rates and in the manner as if this subsection had not been enacted.

(B) There shall then be ascertained an amount equal to 25 per centum of the excess of the net long-term capital gain over the net short-term capital loss. In the case of any taxable year beginning after October 31, 1951, and before November 1, 1953, there shall be ascertained, in lieu of the amount computed under the preceding sentence, an amount equal to 26 per centum of the excess

of the net long-term capital gain over the net short-term capital loss.

(C) The total tax shall be the partial tax computed under subparagraph (A) plus the amount computed under subparagraph (B).

* * * *

(j) *Gains and Losses from Involuntary Conversion and from the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23*(l)*, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described

in subsection (a)(1)(C). Such term also includes timber or coal with respect to which subsection (k)(1) or (2) is applicable and unharvested crops to which paragraph (3) is applicable. Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

* * * *

(2) *General rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sale or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales

or exchanges of capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsection (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

* * * *

(3) *Sale of land with unharvested crop.*— In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted as described in paragraph (2)) at the same time and to the same person, the crop

shall be considered as "property used in the trade or business".

* * * *

Income Tax Regulations 118:

39.23(m)-1. Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.

(a) Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

(b) Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. * * * An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral

deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

* * * *

(e) As used in sections 114(b)(3) and 114(b)(4)(A) and Section 39.23(m)-1 to 39.23(m)-19, inclusive, the term "gross income from the property" means the following:

(1) In the case of oil and gas wells, "gross income from the property" as used in section 114(b)(3), means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. If the oil and gas are not sold on the property but are manufactured or converted into a refined product prior to sale, or are transported from the property prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price (as of the date of sale) of the oil and gas before conversion or transportation.

* * * *

39.23(m)-4. Computation of depletion based on a percentage of income in case of oil and gas wells. Under section 114(b)(3), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27-1/2 percent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property" and "net income of the taxpayer (computed without allowance for depletion) from the property" see Section 39.23(m)-1(e) and (g)). In no case shall the deduction computed under this section be less than it would be if computed upon the cost or other basis of the property provided for in section 113.

* * * *

Paragraph 39.112(b)(1)-1. Property Held for Productive Use in Trade or Business or for Investment.

(a) As used in section 112(b)(1) the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not

material, for such fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

(b) No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose, or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate, or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

APPENDIX B

G. C. M. 12118

C. B. XII-2, p. 119

RevenueAct of 1928

An unlimited conveyance for a cash consideration of the lessor's reserved royalty under an oil and gas lease, or a fractional interest therein, may be treated as a sale of a capital asset within the purview of the capital gains provision (section 101) of the Revenue Act of 1928, provided the interest in the property sold otherwise falls within the definition of the term "capital assets" as defined in section 101.

An opinion is requested whether, in view of the decision of the Supreme Court of the United States in the case of *Burnet* v. *Harmel* (287 U. S. 103, Ct. D. 611, C. B. XI-2, 210), an unlimited conveyance for a cash consideration of the lessor's reserved royalty under an oil and gas lease, or a fractional interest therein, may be treated as a sale of a capital asset under section 101 of the Revenue Act of 1928.

In *Burnet* v. *Harmel*, *supra*, the Supreme Court of the United States held that where an owner in fee executes *an oil and gas lease* for a specified term and as long thereafter as oil and gas shall be produced by

the lessee, in consideration of a cash bonus and stipulated royalties measured by the production of oil and gas, the bonus and royalties are not "gain from the sale or exchange of capital assets" within the meaning of section 208(a)1 of the Revenue Act of 1924, but are taxable as ordinary income. The court said that irrespective of any particular characterization of the payments in the local law, for the purpose of applying the capital gains provision the Revenue Acts of Congress have their own criteria, and when judged accordingly an oil and gas lease is not to be described as a "sale" of the mineral content of the soil, using the term either in its technical sense or as it is commonly understood. Referring to its prior decisions under the corporation excise tax law of 1909, the Supreme Court said that "they established, for purposes of defining 'income' in a tax measured by it, that payments by lessees to lessors under mining leases were not a conversion of capital, as upon a sale of capital assets, but were income to the lessor, like payments of rent," citing *Stratton's Independence, Ltd.*, v. *Howbert* (231 U. S. 399); *Goldfield Consolidated Mines Co.* v. *Scott* (247 U. S. 126); *Stanton* v. *Baltic Mining Co.* (240 U. S. 103); *Von Baumbach* v. *Sargent Land Co.* (242 U. S. 503); and *United States* v. *Biwabik Mining Co.* (247 U. S. 116). The decision in *Burnet* v. *Harmel*, supra, confirmed a line of opinions of the Board of Tax Appeals, including *Henry L. Berg et al* v. *Commissioner* (6 B. T. A. 1287); *John T. Burkett* v. *Commissioner* (7 B. T. A. 560); *James R. Parkey et al* v. *Commissioner* (16 B. T. A. 441); *Henry Harmel* v. *Commissioner* (19 B.

T. A. 376); and *W. P. Ferguson* v. *Commissioner* (20 B. T. A. 130).

The Board of Tax Appeals has held that a conveyance by deed, for a cash consideration, of an interest in the lessor's mineral rights, subject to an existing oil and gas lease under which the lessee has the right to operate for a term of years or so long as oil or gas is produced from the land by the lessee, constitutes a sale of a capital asset within the capital gains provision (section 206) of the Revenue Act of 1921. (*J. E. Murphy* v. *Commissioner*, 9 B. T. A. 610, C. B. VIII-2, 37, and *J. D. Reynolds* v. *Commissioner*, 10 B. T. A. 651, C. B. VIII-2, 44.) A fractional interest in the royalty reserved under the lease was considered to have passed to the grantee as an incident of the conveyance in each of the cases cited.

The Board has also decided that the conveyance for a cash consideration of a fractional interest in a reserved royalty as such is a sale of property within the meaning of section 202 of the Revenue Act of 1921, and that the grantor of such an interest is not entitled, in determining taxable income, to apply against the consideration received a depletion deduction based upon the discovery value depletion base provided for in section 214(a)10 of the Revenue Act of 1921. (*Appeal of Anna Taylor*, 3 B. T. A. 1201; *J. M. Hudson* v. *Commissioner*, 14 B. T. A. 983.) These decisions of the Board sustained the position of the Commissioner. If such a conveyance of a reserved royalty, or a fractional interest therein constitutes a sale of property for

the purposes of section 202 of the Revenue Act of 1921 it also qualifies as a sale of a capital asset under section 206 of that Act, assuming that the reserved royalty is an interest which the *lessor has owned for more than two years prior to the conveyance.*

The Bureau has held following the Board's decision in the case of *J. E. Murphy* v. *Commissioner*, supra, that a conveyance by royalty deed of a fractional interest in the oil, gas and other minerals under certain lands, and in the royalty rights in respect thereto, without limitation as to duration of time is "a sale of capital assets," and that the provisions of section 208 of the Revenue Act of 1926 are applicable to such a sale. (I. T. 2524, C. B. IX-1, 199.) In such a case the fractional interest in the reserved royalty passes to the grantee as an incident of the grant of a fractional interest of the lessor's reserved oil and gas rights subject to the lease.

As heretofore indicated, the case of *Burnet* v. *Harmel*, supra, establishes the principle that all payments from lessee to lessor under an oil and gas lease are income from the use of the land and are not gain from the sale or conversion of capital assets. This rule should be applied in all cases where the instrument of grant may be classified properly as a lease. *This office is of the opinion, however, that in the case of an unlimited conveyance for a cash consideration of the lessor's reserved royalty under an oil and gas lease, or of a fractional interest therein, as in the cases of J. E. Murphy v. Commissioner, supra, and the Appeal of*

Anna Taylor, supra, the conveyance may be treated as a sale of a capital asset within the purview of the capital gains provision (section 101) of the Revenue Act of 1928, provided the interest in the property sold otherwise falls within the definition of the term "capital assets" as defined in section 101. (Emphasis supplied)

G. C. M. 22730, C. B. 1941-1, p. 214

INTERNAL REVENUE CODE AND PRIOR REVENUE LAWS

Status of oil and gas leasing transactions for Federal income tax purposes, including review of controlling cases and discussion of issues relating to acquisition and assignment of interests in oil and mineral properties, the division of income derived from the sale of the product among the parties entitled to share therein, and the depletion allowances granted such parties.

An opinion is requested with respect to the status of oil and gas leasing transactions for Federal income tax purposes, the acquisition and assignment of interests in oil and mineral properties, the division of income derived from the sale of the product among the parties entitled to share therein, and the depletion allowances granted such parties.

The following supposititious case presenting the questions involved may be stated for convenient consideration. A, as a fee owner of oil lands, leased the lands to B in consideration of a cash payment of $100,000, an additional $100,000 payable out of one-sixteenth of the oil and gas if, as, an when produced, and a one-eighth royalty interest. B then assigned his leasehold interest to C in consideration of a cash payment of $200,000, and an additional $100,000, payable only out of one-sixteenth of the oil and gas if, as, and when produced. C assigned one-half of the lessee interest to D, who agreed to develop and operate the property, to advance C's share of the funds necessary for development costs and operating expenses, to sell all the oil produced and saved and credit C with one-half of the proceeds until all advances were fully recouped, and thereafter to operate the property and pay one-half of the proceeds from the sale of all oil produced, less one-half of the operating expenses, to C, who was not personally liable for any costs or expenses incurred or advances made. E drilled an oil well under an agreement with D entitling E to have delivered to his credit one-eighth of all the first oil and/or gas if, as, and only when the same is produced, saved, and marketed from the land until he received the sum of $25,000. *Also, F paid D the sum of $15,000, which D convenanted to use in developing the property, and D agreed to pay F the sum of $25,000, payable out of one-eighth of the oil and/or gas, if, as, and only when the same is produced, saved, and marketed from the leased land.*

In *Lynch* v. *Alworth-Stephens Co.* (267 U. S. 364, T. D. 3690, C. B. IV-1, 162 (1925)) and cases therein cited, the United States Supreme Court, though it expressly recognized the hardship involved in treating all proceeds from the extraction and sale of ore as ordinary income in view of the fact that mining operations reduce the value of property interests in mineral deposits, made it clear that such reduction in value is not depreciation but depletion, and that the capital investments in minerals of both the lessor and the lessee are returnable to them tax-free only through depletion deductions expressly granted by statute. (See also *Helvering* v. *Mountain Producers Corporation*, 303 U. S., 376, Ct. D. 1321, C. B. 1938-1, 343, wherein the Court stated that the depletion allowance rests upon legislative grace.)

Though the Revenue Act of 1916 did not expressly provide for the allocation of depletion between the parties in interest, the Court in the Alworth-Stephens case regarded both the lessor and the lessee of mining property as owning valuable property rights in the mineral in place which were reduced in value through the extraction of ore, and it held the total depletion allowable was allocable between the lessor and the lessee in proportion to the interests of each severally considered.

Subsequent decisions hold that the incidental exhaustion of natural deposits through the production and sale of oil or minerals is not a sale or conversion of capital assets allowing cost or basic value to be re-

covered tax-free. Further, a sale of capital assets is not involved in a lease agreement in which the lessor, in consideration of a bonus or lump sum cash payment made at the time the lease was executed (hereinafter referred to as a "bonus") and stipulated royalties measured either by a percentage of production under the lease or by a stated sum per unit extracted and sold (hereinafter referred to as "royalties") which are payable over the entire lease life, grants a lessee the right to enter upon and use the land for purposes of exploitation. (See *Bankers Pocahontas Coal Co.* v. *Burnet*, 287 U. S., 308, Ct. D. 618, C. B. XII-1, 272 (1933), and *Burnet* v. *Harmel*, 287 U. S. 103, Ct. D. 611, C. B. XI-2, 210 (1932), involving ordinary royalties paid a lessor of coal lands on the basis of a fixed amount per ton mined, and a bonus paid the lessor of oil lands, respectively.) The Court thus not only recognized that royalty payments like rental payments are ordinary income to the lessor, but drew an analogy between cash bonus payments made upon the execution of an oil and gas or mining lease and a substantial payment received in the first year by a lessor in any other type of lease for purposes of classifying such bonus payments as ordinary income rather than proceeds from the sale of capital assets.

Such classification of bonus payments does not depend upon whether the local law regards the agreement between lessor and lessee as a lease or a sale of natural resources in place. In *Palmer* v. *Bender* (287 U. S., 551, Ct. D. 641, C. B. XII-1, 235 (1933)) the Court refused to distinguish between lessors and sub-

lessors or assignors of leasehold interests who, by stipulation for royalty payments, reserve an interest in production coextensive with the leasehold life. The taxpayer therein was a member of several partnerships, each of which had acquired an oil lease, had discovered oil, and had then assigned the lease to a third party in consideration of a bonus payment, a future payment of a stated sum to be made out of one-half of the first oil produced and saved (which type of payment will hereinafter be referred to as an "oil payment"), an interest which does not by its terms extend throughout the lease life, and an additional "excess royalty" of one-eighth of all of the oil produced and saved. The Court held that the bonus payment, the oil payments, and the royalty payments were ordinary income to the sublessor or assignor subject to the depletion allowance, rather than proceeds from the sale of capital assets. The Court refused to distinguish between leases governed by varying State laws which apply different rules as to when technical title to oil and gas passes to the lessee, on the ground that the economic consequences to the lessor are the same in all cases—i.e., the value of his interest is lessened by the extraction of oil. The Court stressed the general view that all persons having a right to share in the oil produced or the proceeds from its sale, irrespective of the legal form of their interest in the property, have an economic interest in the oil and gas in place to which the depletion provisions are applicable, the language of the statute, providing that the depletion allowance shall be allocated between lessor and lessee, being held to be broad enough to provide, at

least, for every case in which the taxpayer has acquired by investment any interest in the oil in place, or has secured, by any form of legal relation, income derived from the extraction of oil to which he must look for a return of his capital. The opinion states that a lessor, or sublessor or assignor, who stipulated for the payment of future royalties in kind from the oil produced and saved, had retained an economic interest in the oil and gas in place entitling him to depletion deductions against cash bonus payments as well as proceeds from his share of the oil. The opinion inplies that the proceeds from the sale of any share in the oil produced are income subject to depletion in the hands of the one entitled to such share. Further, the Court speaks of the oil and gas in place as a reservoir of the capital investments of the several parties entitled by agreement to share in the oil and gas produced under the lease.

Such language indicates that the Court regarded the contracts between the interested parties as dividing the property rights in oil and gas in place in accordance with their respective shares upon production. That is, the lessor, by lease terms reserving royalties, merely grants to the lessee exclusive exploitation privileges, retaining as his share of the oil and gas in place that portion thereof which, freed of the burdens of development and operating costs, has a value equivalent to the value of the entire interest subject to such burdens, and, therefore, like the lessor of an ordinary lease reserving rent, is regarded as not having disposed of a capital asset. The remaining fractional interest

in oil and gas in place becomes the share of the lessee's working or operating interest which carries the risks and burdens attending exploitation. If the lessee in turn subleases or assigns the working interest, reserving a royalty share, he acquires a status comparable to that of a lessor with respect to the share retained, any further burden of exploitation being passed on to the sublessee or assignee with an agreed share in the oil and gas produced. So considered, the view that a lessor, or a sublessor or assignor, parts with no capital interest, though the lessee, or sublessee or assignee, acquires a capital interest upon the execution or assignment of a lease, presents no logical difficulties, as the lessee interest, though it may have great potential value, ordinarily becomes valuable only upon investment by the lessee in exploitation or by reason of discovery. Under this theory, the lessee does not pay rent to the lessor by royalty payments but, instead, divides the product or the proceeds realized therefrom with him. Thus, in the classification of royalty payments as "rent" to the lessor, the term is employed as denoting a sharing by the lessor for the use of his land rather than as an amount owing and paid by the lessee. A cash bonus, though termed an advance royalty payment, paid to a lessor without regard to production and often in a year when there is no production, is not a division of products or proceeds therefrom. Nor, as already noted, does it represent proceeds from the sale of a capital asset to a lessor reserving a royalty interest. The lessor does not sell an interest to the lessee. Instead, the lessee acquires an

interest by assuming the obligation to develop and operate the property.

The analogy between the bonus payment accompanying a mineral lease and a large payment made in the first year of any ordinary lease, to which the Court resorted to characterize the bonus payment as ordinary income as distinguished from capital gain to the lessor, does not establish an identity of character in the two types of payments for Federal income tax purposes. An oil or mineral lease differs from an ordinary land lease in that it contemplates severance and disposition of valuable mineral deposits that normally represent a large percentage of land values. Further, the allowance of depletion deductions to the lessor, which serve to offset his bonus income and reduce the basis of his interest, establishes the distinction between such payments by treating the bonus payment upon an oil or mineral lease as, in part, a tax-free return of the lessor's capital investment in mineral in place. As the mineral in place is a reservoir of the capital investments of the parties returnable through the depletion allowance, and as the bonus payment results in a reduction in the lessor's capital investment to the extent of the depletion allowable thereon, if follows that such payment is a contribution by the lessee to such reservoir of capital investments which is substituted for the capital thereby withdrawn by the lessor. Such shifting of capital investment is attended by a corresponding shift in the value of the respective capital interests or share rights of the parties. That is, a bonus payment diminishes the value of the lessor's

mineral interest by reducing his royalty share in future production. The depletion allowance on his bonus income is designed to compensate him for such diminution in value of his interest thereby sustained. Correspondingly, the bonus payment enhances the value of the lessee's interest by giving him a larger share of the minerals produced, or the proceeds therefrom, by reason of his bonus investment.

It will be noted that the analogy between a bonus payment made upon the execution of an oil or mineral lease and a large rental payment made in the first year of any ordinary lease, upon which the Supreme Court based its conclusion that such bonus payment was ordinary income in the nature of an advance royalty payment subject to the depletion allowance rather than proceeds from the sale of a capital asset, is not available to permit of like treatment of a cash payment made where no royalty right is reserved by the payee. Royalty rights represent a share in all of the oil or mineral in place, and a bonus payment which reduces the royalty and, therefore, the lessor's capital interest in every unit of oil or mineral content may properly be termed an advance royalty. *Unlike ordinary rights to rent or royalty, oil payment rights represent share rights in only a portion of the oil or mineral content of the land. When the stipulated payments are made, the payee's interest in oil or mineral expires. A cash payment made upon the execution of an instrument stipulating only for oil payments is, therefore, regarded not as an advance royalty payment but as proceeds from a sale in which the payee disposed of his economic*

interest in oil or mineral in place, less the fraction thereof represented by the oil payment rights reserved by him. (See *Commissioner* v. *Fleming*, 82 Fed. (2d), 324.)

It thus appears that (1) agreements to pay royalties measured by a fraction of the mineral product or the proceeds therefrom, or by a stated sum per unit extracted and sold, in effect divide the proceeds from production, and (2) cash bonus payments representing advance royalty payments effect a substitution in the reservoir of capital investments of lessee invested capital for invested capital withdrawn by the lessor in the amount of depletion sustained by him, thereby giving the lessee a larger share upon production and, consequently, a greater interest in natural deposits in place than he would have had if there had been no cash bonus payment. A cash payment representing proceeds from the sale of an economic interest also accomplishes a substitution of payor invested capital for payee invested capital. The payee in such a case realizes capital gain or loss measured by the difference between cost allocable to the interest sold and the proceeds received.

The stated basic concepts of income and the attending depletion allowances apply to depletion provisions basing allowances on percentages of gross income from the properties as well as to the provisions of the earlier Acts granting allowances based upon cost or value at March 1, 1913, or upon discovery value. In *United States* v. *Dakota-Montana Oil Co.* (288 U. S., 459, Ct.

D. 655, C. B. XII-1, 243 (1933)), treating capitalized intangible costs of development as returnable through the depletion allowance, the Court pointed out that there is "no ground for supposing that Congress, by providing a new method for computing the allowance for depletion intended to break with the past and narrow the function of that allowance." The Court said that the "reasonable inference is that it did not and that depletion includes under the 1926 Act precisely what it included under the earlier Acts.". In *Herring* v. *Commissioner* (293 U. S., 322, Ct. D. 904, C. B. XIV-1, 303 (1935)) the Court stated that the nature and purpose of the allowance based on a percentage of income are the same as in the case of the allowance based on cost, and allowed a lessor receiving an advance royalty or bonus payment upon the execution of an oil and gas lease a percentage depletion allowance thereon. The fact that such an allowance is in anticipation of production was stated to be no more persuasive under the percentage depletion provisions than it was under the depletion provisions of the earlier Acts.

Aside from such bonus payment to a lessor or assignor, the term "gross income," as used in the phrase "gross income from the property" in the percentage depletion provisions, means the same as "gross income" in the provisions generally defining income, with the qualification that the phrase "gross income from the property" in the depletion provisions is confined to the gross income from the extraction of oil rather than gross income from the tract of land in all its uses. (See *Helvering* v. *Twin Bell Oil Syndicate*,

293 U. S., 312, Ct. D. 905, C. B. XIV-1, 253 (1935), involving an assignee of an oil and gas lease which was obligated to pay royalties in cash or in kind totaling one-fourth of the oil extracted.) The taxpayer-assignee in *Helvering* v. *Twin Bell Oil Syndicate, supra,* contended that the entire gross income from production of oil and gas was its gross income from the property and claimed the deduction of 27½ per cent thereof as its allowance for depletion. The Court held that the income from production and sale of the products and the depletion allowance thereon, however measured, must be apportioned between lessor and lessee. Thus the Court confirmed the implications of the earlier cases involving lessors and sublessors or assignors by applying the basic concepts as to (1) gross income from production, and (2) depletion allowances and their division between the respective parties interested.

In the last-cited case the Court, in effect, pointed out that an agreement to pay royalties represents a sharing arrangement between the parties by expressing the view that the provision of a later Act, section 114 (b) 3, *Revenue Act of 1932,* which expressly excludes royalties paid or incurred in respect to the property from the lessee's gross income from the property, was merely declaratory of existing law. This implication as to division between the parties by means of royalty payments was confirmed and extended to include divisions effected by agreements to make oil payments in *Thomas* v. *J. J. Perkins et al* (301 U. S., 655, Ct. D. 1237, C. B. 1937-1, 162), wherein proceeds from the share of oil reserved by an assignor were held

not to be income to the assignee. In that case, lessees of oil and gas leases assigned the leases for $395,000, payable out of one-fourth of the oil produced free of any share of development expense or any other burden. The Palmer case, *supra*, was cited as supporting the view that the oil payment interest retained by the assignors gave them ownership of the stipulated share of the oil and entitled them to the income therefrom and the depletion allowance thereon. The *Twin Bell Oil case, supra*, was cited as holding that it is immaterial whether the lessor, or sublessor or assignor, is to receive the royalty in oil or the proceeds from the sale of his share of such oil by the lessee.

The cited cases show that the stated basic principles apply equally to mineral deposits and to oil and gas. Like issues arise in the oil and mineral cases which are cited interchangeably in the evolution of the applicable rules. *The parties entitled to share in oil or mineral extracted, or the gross proceeds therefrom (including the parties to a lease providing for royalty payments of stated amounts per unit mined), have economic interests in the oil or minerals in place. That is, they, as owners of the rights in oil or other mineral in place, share the income from production, and the depletion allowances thereon are regarded as designed to permit tax-free recovery of at least their capital investments in such property rights.* (See also the *Mountain Producers case, supra*, wherein the royalty payable by the producer was measured by a per unit price based on current gasoline prices.)

It will be noted that the persons entitled to oil payments or royalty payments, which the above-cited cases have characterized as the owners of economic interests in oil or mineral in place, by the terms of the agreements from which these rights arise, are assured of a share if there is production of oil or mineral. *J. Steve Anderson et al* v. *Helvering* (310 U. S., 404, Ct. D. 1456, C. B. 1940-1, 108) confirms this view. The obligation there involved was not an ordinary oil payment right, as it was payable out of proceeds from oil produced or proceeds from resale of the properties. Payment out of proceeds from resale would liquidate the obligation and terminate the right to share in production income.

Assurance of a share upon production marks ownership of an economic interest in oil and gas in place. Division of production income and the attending depletion allowances between owners of economic interests necessarily exclude all others. The right to share in production or gross income therefrom should not be confused with a contractual right to purchase and process a product of the mine or well, even though such processing incidentally aids production and is done under a sharing of the processed product with the producers. In *Helvering* v. *Bankline Oil Co.* (303 U.S., 362, Ct. D. 1323, C.B. 1938-1, 306) the taxpayer contracted with producers of oil and gas for the treatment of wet gas to produce gasoline. The taxpayer agreed to install and maintain necessary pipe lines and connections from casingheads or traps at the mouth of the well to its plant, and the producers agreed

to deliver the natural gas from which the taxpayer was to extract the gasoline and return part of the dry gas to the well to be used therein for pressure purposes. The taxpayer agreed to deliver one-third of the gasoline extracted or the gross proceeds from the sale of such share. The Court held that the taxpayer was a mere purchaser of the gas produced from the well and not a producer of gas having a depletable economic interest in mineral in place. It should be noted that the taxpayer's capital investment was in equipment facilitating delivery of the gas produced rather than in equipment for production of gas, and that its function was not production of gas but the processing of gas. The *Mountain Producers case, supra*, is distinguishable in that the refining company purchaser therein was a producer and was required to make the capital investments necessary to production that gave the producer an economic interest in oil and gas in place.

Similarly, a right to share in production, or the gross income therefrom, is very different from the right to share in the net income of the producer (a right measured not by production of mineral, as such, but by the degree of success in operation of such a right owned by another). (See *Helvering* v. *Elbe Oil Land Development Co.*, 303 U.S., 372, Ct. D. 1322, C.B. 1938-1, 293, as interpreted by the *Anderson case, supra*, and *Helvering* v. *O'Donnell*, 303 U.S., 370, Ct. D. 1324, C.B. 1938-1, 337.) In the *Elbe case, supra*, the rights in oil properties and equipment were trans-

ferred for a stated consideration payable in annual installments, irrespective of production from the properties transferred, plus one-third of the net profits derived from operation of the properties by the purchaser after it had been reimbursed from oil and gas proceeds for all expenditures made by it in the acquisition, development, and operation of the properties. The interest of the seller was thus limited to a right to share in net income after recoupment of capital expenditures rather than gross proceeds from production. In the *O'Donnell case, supra*, stock of a corporation owning oil property rights was sold to another corporation (which was to take over in liquidation of the oil properties of the first corporation and operate them) for a one-third share of the net profits derived from the operation of the oil properties. In both cases, the Court held the transfers to be sales, and that in neither case did the transferor have a depletable economic interest in the mineral in place after the transaction had been completed.

It seems clear that the right to share in production, or the gross proceeds therefrom, which distinguishes ownership of depletable economic interests in oil or mineral in place from nondepletable economic advantages, including contractual rights to purchase the product or to share in net income, does not depend upon legal title to the oil and gas or mineral deposits. (*Burnet* v. *Harmel, supra*, and *Palmer* v. *Bender, supra.*) Also, as noted above, in the Palmer case, technical legal description or characterization of the

right was treated as immaterial, the Court saying that the owner of a depletable economic interest includes any taxpayer who "has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital." In the *Anderson case, supra*, the Court in discussing the *Perkins case, supra*, involving an oil payment right reserved upon assignment, said the "decision did not turn upon the particular instrument involved, or upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for payments . . . that type."

Such language seems as applicable to grants as to reservations of economic interests, as the formalities of the conveyancer's art are quite as exacting in the reservation of interests as in the grant of interest. If, as the Court indicates, the mere stipulation for oil payments to a person having an investment or capital interest in oil properties amounts in effect, to a retention of a depletable economic interest in oil in place to the extent of such oil payments, then it would seem to follow that an agreement entitling one making an investment (thereby acquiring a capital interest) in such properties to such payments would give him a corresponding depletable economic interest therein. The point assumes importance in view of the many contracts entered into by owners of lessee interests with well drillers to drill wells, equipment dealers to furnish equipment, and investors to furnish

money for use in developing the leased property in return for agreements to make stated payments out of a share of the oil. By such arrangements, a lessee commonly lessens his own investment and the risks and burdens attending development by agreements to share the investment obligation and the proceeds of production. The Lessee or assignee, like the lessor or assignor who retained a share interest in production having a value equivalent to that of the lessor's prior interest but passed on to the lessee the investment obligations and risks that attend development for a share in production, has parted with no capital interest but has merely in turn given another a right to share in production in consideration of an investment made by such other person. If the driller or equipment dealer is making an investment by which he acquires an economic interest in oil and gas in place, expenditures made by him represent capital expenditures returnable tax-free through the depletion allowance rather than by way of expense deduction, and the oil payment rights acquired do not represent payment in property for services rendered or supplies furnished. Similarly, one who, in return for an oil payment right, furnishes money which the lessee is pledged to use in developing the property would be regarded as making an investment representing an addition to the reservoir of capital investments in oil and gas in place (as distinguished from the purchase of an oil payment right from the lessee wherein there is no such pledge to invest the proceeds in development and the buyer's capital investment would replace the lessee's capital

investment allocable to the interest sold). Such a transaction, involving a pledge to use the money furnished in developing the property, is distinguishable from a sale the proceeds of which are unqualifiedly received by the seller. This view seems to accord with the realities of such transactions. In none of such cases has the lessee parted with a capital asset, and the investments involved are not his investments.

The stated principles seem applicable irrespective of whether there are words purporting to convey an interest in the oil in place involv in the oil payment rights. Both the practical and economic consequences of provisions for payments of this type are identical in either case. *It seems generally agreed that, irrespective of conveyancing formalities, a right to a share of the oil produced carries with it a corresponding interest in the oil in place.* That rights to share in the oil produced are analogous to rights to share in gross proceeds derived from the sale of oil produced has been repeatedly stated by the highest Court. It would seem to follow that a right to a share of the proceeds from the sale of oil produced would give the payee ownership of a corresponding depletable economic interest without regard to conveyancing formalities.

It thus appears that the controlling cases regard capitalized development costs as representing investments returnable through the depletion allowances, whether the total development investment is made by a landowner who elects to develop the property him-

self and take all the oil or mineral or is shared by a number of investors who, by contractual arrangements between themselves, agree to divide the resulting oil or mineral product or the proceeds from the sale of such product. If the latter, the division of oil, or the gross income therefrom, determines the economic ownership of oil or mineral in place as well as the gross income and attending depletion allowances. Under this test, the form of the contracts dividing the product or the gross income therefrom, or the legal phraseology or devices utilized to accomplish the division, are immaterial. For example, an instrument purporting to be a "lease" of oil or mineral lands, which gave a "lessee" a right to explore for and produce all the oil or mineral found thereon and required the "lessee" to pay the "lessor" only a share of the net profits derived from the operation (as distinguished from a share of the product or the proceeds from the sale of the product), would leave the "lessor" without a depletable economic interest in the oil or mineral in place, and a "bonus" payment, if any, made upon the execution of such instrument would represent proceeds from the sale of a capital asset. Such results accord with the realities of the test supplied. Under such an agreement, the lessee may exhaust a substantial oil or mineral content with little or no realization of net profits, in which event the lessor will receive little or nothing under the contract. That being true, the lessor in effect has not retained an interest in the oil or mineral content.

Similarly, the Federal income tax status of a "carried interest" depends upon the extent to which such interest in effect represents a right to share in gross income as distinguished from net income derived from the operation. In *Reynolds* v. *McMurray* (60 Fed. (2d), 843, certiorari denied 287 U.S., 664, Ct. D. 616, C.B. XII-1, 198 (1933)), McMurray was the owner of an undivided interest in oil leases, subject to a contract with the Ohio Oil Co., which also owned an undivided interest in such leases. Under the contract, the parties agreed that the Ohio Oil Co. was to manage, control, develop, and operate such leases and pay all costs incident thereto and charge McMurray's undivided interest with its proportionate part thereof; that it should market the oil and gas produced and account to McMurray for his proportionate part thereof; that it should be reimbursed by McMurray from the proceeds derived from the sale of his proportionate part of the oil and gas, to be effected by crediting McMurray's account with the Ohio Oil Co., on the 1st of each month, with the proceeds derived from the sales during the month preceding of his proportionate part of the oil and gas; and that it should make monthly remittances to him of his proportionate share of any proceeds remaining after deducting the amounts due it for expenditures made by it for him.

The economic or practical effect of such contract was to turn over the leasehold estate to the Ohio Oil Co. for development and the extraction and sale of the product. Though McMurray retained legal title to

his undivided interest under the lease, he contracted away the only right granted thereby—i.e., to extract and sell the oil content of the leased land. Thereafter, the development and operation of the property were carried on by the oil company on its own behalf and not as a joint operation by co-owners. Proceeds from the sale of oil were not divided between the parties. Charges and credits in the account between the parties did not reflect actual obligations between them. Rather, they were merely factors in computing the net income payments which were all McMurray could ever become entitled to under the agreement, regardless of how much oil was extracted and sold from the leased premises. McMurray's interest was converted into a mere contractual right to share in any net income derived from the sale after recoupment of all capital invested by the oil company. The oil company was obligated to make all of the investment necessary to develop the property and to pay all the costs of operation, and it could look only to the proceeds from the sale of the lessee share of oil and gas produced for reimbursement of its capital expenditures and operating expenses. The oil company assumed all the risks and burdens attending development and operation, and it was entitled under the contract to the entire lessee share of production which was the only source from which its capital and expenses could be recouped. Accordingly, such investment was in an economic interest in oil and gas in place measured by the lessee share of production. It is, therefore, the opinion of this office that the decision in that case, holding that

the proportionate share of the proceeds from the sale of oil ostensibly credited to McMurray was constructive income to him, is out of harmony with the above-described test of ownership of income from production, and it should no longer be followed. In cases where, after recoupment of such charges or so-called advances to the "carried interest", the interest ceases to be a "carried interest" and the owner thereof becomes entitled to a share in the oil, or the gross income therefrom, and liable for his share of costs and expenses, he should be regarded as retaining under the contract an economic interest in oil in place, consisting of his undivided interest in the lease less the right of recoupment, which is comparable to an oil payment right, carved out of his fractional working interest.

The questions presented by the supposititious case stated herein are answered generally by the above discussion. Specifically, A, the fee owner, realized $100,000 bonus income when the lease was executed. He also realizes as income one-sixteenth of the proceeds from production until that fraction produces $100,000, and one-eight of such production as royalty income so long as production continues. All of such income is ordinary income. He is entitled to corresponding depletion allowances, and suffers reductions in the bases of his oil payment and royalty interests resulting from such depletion deductions. A lessee who subleased or assigned his interest for like consideration would occupy a comparable position. *The $200,000 which C paid to B was consideration for the sale of B's inter-*

est, less the retained oil payment of one-sixteenth interest until $100,000 is produced. B is not entitled to depletion on the $200,000 cash payment, but he is entitled to depletion on such retained interest. By the "carried interest" arrangement between C and D, the former converts a depletable economic interest in oil in place into a nondepletable contractual right to share in D's net income after recoupment by D of all development costs and expenses. *Had C received a cash payment, it would have represented proceeds realized upon the sale of a capital asset by him.* E, irrespective of words purporting to convey ownership of oil in place, acquired a depletable economic interest to the extent of his oil payment right for a capital investment measured by the expenditure made by him in drilling and equipping the well. *F acquired a like interest for the $15,000 furnished by him to D for development purposes. His interest would have been the same had D not been pledged to expend the $15,000 for development. In that event, however, the transaction would not have been only an investment of the stated sum by F but a sale of an oil payment interest by D, and the latter would have been required to allocate thereto a part of his basis and compute gain or loss.* D, of course, acquired an economic interest consisting of the seven-eights working interest, less the oil payment rights agreed upon by him or his predecessors and held by A, B, E and F. His invested capital account does not include the investment sums contributed by E or F under their contracts with him, but it does include the amount "advanced" by him for

C's share of capitalized development cost. (Emphasis supplied).

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I.T. 3693

C.B. 1944, p. 272

Internal Revenue Code

The interest of a lessee in oil and gas constitutes an interest in "real property" for Federal income tax purposes. Certain leasehold interests sold by the M Company constitute "real property used in the trade or business of the taxpayer" within the meaning of section 117(a)(1) of the Internal Revenue Code, as amended by section 151 (a) of the Revenue Act of 1942, and are, therefore, excluded from the term "capital assets" as defined therein. However, if such leasehold interests were held for more than six months, they qualify as "property used in the trade or business," as defined in section 117(j) of the Code, as added by section 151(b) of the Revenue Act of 1942, and are subject to the treatment provided for in that section.

Advice is requested whether the interest of a lessee in oil and gas constitutes an interest in "real property" for Federal income tax purposes, and, if so, whether certain oil and gas leases sold by the M Company constitute "real property used in the trade or business of the taxpayer" within the meaning of section 117(a)(1) of the Internal Revenue Code, as amended by section 151(a) of the Revenue Act of 1942, and are, therefore, excluded from the term "capital assets" as defined therein. Advice is also requested whether, if such leases were held for more than six months, they qualify as "property used in the trade or business," as defined in section 117(j) of the Code, as added by section 151(b) of the Revenue Act of 1942, and are subject to the treatment provided for in that section.

Prior to the amendment of section 117 of the Code by section 151 of the Revenue Act of 1942, leasehold interests, whether realty or personalty under State law, were within the capital asset classification. Machinery and equipment and other depreciable property were, however, specifically excluded from this classification. In the amendments made to section 117 of the Code by the Revenue Act of 1942, Congress considered it "more appropriate to treat all property used in the trade or business alike, and not to distinguish between land and other property used in the trade or business." (See Finance Committee Report, C.B. 1942-2, 594.) Accordingly, "real property used in the trade or business" is no longer included in the

definition of a "capital asset," but (except in the case where such property is held primarily for sale to customers in the ordinary course of business) such property may be grouped with certain other assets with the result that "net gains" from all dealings therein are taxable as long-term capital gains, and "net losses" from such dealings may be treated as ordinary losses. This result applies upon a sale, exchange, or involuntary conversion, and the assets included within the group are limited to: (a) Those assets held more than six months used in the trade or business of the taxpayer which are either "real property" or property of a "character subject to the allowance for depreciation," and (b) capital assets held more than six months when the gain or loss results from an involuntary conversion. (See section 29.117-7 of Regulations 111.)

The Federal revenue laws are not to be deemed subject to State law unless the express language or necessary implication of the section involved so requires. (See *Burnet* v. *Harmel*, 287 U.S., 103, Ct. D. 611, C.B. XI-2, 210 (1932); *Helvering* v. *Stuart et al.*, 317 U.S. 154, Ct. D. 1566, C.B. 1942-2, 198.) *The Supreme Court of the United States has held that, for Federal income tax purposes, persons sharing in the depletion allowance with respect to oil leases are characterized as owners of economic interests in oil or mineral in place, regardless of the technical provisions of the instrument creating the lessee's interest.* (See *Palmer* v. *Bender*, 287 U.S., 551, Ct. D. 641, C.B. XII-1, 235 (1933) and *Thomas* v. *Perkins et al.*,

301 U.S. 655, Ct. D. 1237, C.B. 1937-1, 162.) *Accordingly, for Federal income tax purposes, it is held that the interest of a lessee in oil and gas constitutes an interest in "real property."* With respect to the instant lease hold interests, they are held to constitute "real property used in the trade or business of the taxpayer," within the meaning of section 117(a)(1) of the Code, and they are, therefore, excluded from the term "capital assets" as defined therein. However, if such interests were held for more than six months, except with respect to a dealer therein, they will qualify as "property used in the trade or business," as defined by section 117(j) of the Code, and they are subject to the treatment provided by that section.

The specific questions presented and the answers thereto, assuming the M Company is not merely a dealer in leases, are as follows:

1. Are oil and gas leases held by the M Company real property used in the trade or business and so excluded from the definition of capital assets in section 117(a) of the Internal Revenue Code regardless of State law?

Yes, as explained above. The characterization of oil and gas leases (as "real property" or otherwise) under the laws of the various States is immaterial.

2. If oil and gas leases are real property used in the trade or business and are, therefore, excluded from the definition of capital assets, are they subject to the provisions of section 117(j) of the Code?

Sales of oil and gas leases are subject to the provisions of section 117(j) of the Code, if such leases are held for more than six months.

3. If an oil and gas lease is subject to the provisions of section 117(j) of the Code and the gains upon sales or exchanges of property covered by section 117(j) of the Code exceed the losses, is it possible to have an installment sale of an oil and gas lease so that the seller may have the benefit of the installment sale provisions of section 44 of the Code?

Gains from the sale of oil and gas leases which are treated as capital gains under section 117(j) of the Code may be reported on the installment basis under section 44 of the Code, if they otherwise meet the requirements of that section and the regulations promulgated thereunder. (See section 29.117-7 of Regulations 111. See also in this connection, however, G.C.M. 21714, C.B. 1939-2, 218, and *Golden v. Commissioner*, 47 B.T.A., 94.)

4. Is there any distinction to be made between leases that produce oil and gas and those that

are acquired and held for a time and sold without being drilled?

If the leases were acquired with the intention of producing oil or gas and were sold before production, they would be treated the same as producing leases. If, however, a taxpayer is a dealer in leases which are held primarily for sale to customers in the ordinary course of his trade or business, they are excluded from the term "capital assets" under section 117(a) of the Code. (See *Greene et ux* v. *Commissioner*, 141 Fed. (2d) 645.)

5. Are leases held by the M Company in Texas, Kansas, and Louisiana subject to the same rules? If different rules are applicable, please give the rules for each of these States.

The rules set forth herein are applicable for Federal income tax purposes, as explained above, irrespective of the characterization of such leases under the laws of the various States. (Emphasis supplied).

G.C.M. 24849

C.B. 1946-1 p. 66

Internal Revenue Code

Consideration received for the assignment of a short-lived in-oil payment right carved

out of any type of depletable interest in oil and gas in place is ordinary income subject to the depletion allowance where such consideration is not pledged for use in further development.

An opinion is requested with respect to the status, for Federal income tax purposes, of cash payments to owners of depletable economic interests in oil and gas in place as consideration for assignments of in-oil payment rights carved out of the economic interests held by them. Such rights entitle the assignee to oil or gas produced, or the proceeds derived from an agreed share of production if, as and when produced, until a fixed or determinable amount of oil or gas, or an ascertainable sum of money, has been received. *Such rights ordinarily pay out and expire within one or two years.*

G.C.M. 22730 (C.B. 1941-1, 214) deals with the issue only to the extent of distinguishing the case in which an operator assigns an in-oil payment right in return for cash which he is pledged to use in the development of the property (in which event such cash payment is not income to the assignor and its use for the pledged purpose is not regarded as an expenditure by the assignor) from the instant case which involves an outright purchase of an in-oil payment right for cash "wherein there is no such pledge to invest the proceeds in development and the buyer's capital investment would replace the lessee's capital investment

allocable to the interest sold." This statement, made parenthetically in G.C.M. 22730, supra, at page 222, was not enlarged upon there. Consideration must now be given to the Federal income tax effect, in the case of the assignor, of a transaction wherein he receives unqualifiedly a cash payment for an in-oil payment right. Is such cash payment ordinary income or proceeds from the sale of a capital asset? If it is the latter, the capital gain is measured by the cash payment less the allocable part of the basis of the assignor-operator in the oil and gas in place, plus the estimated cost to him of producing the oil involved in the oil payment right—an obligation he assumes without further cost to the assignee.

G.C.M. 22730, supra, recognizes that the holder of an in-oil payment right, however acquired, has a depletable economic interest in the oil and gas in place, which is potentially a capital asset in his hands, provided the conditions of that classification under section 117 of the Internal Revenue Code are met. Such conclusions as to the status of the in-oil payment right in the hands of the grantee are not determinative of the nature of the transaction in the case of the grantor. As pointed out in the cited opinion, the controlling decisions hold that a landowner who grants a lease, or a lessee who subleases or assigns his lease, in consideration of a cash bonus payment and an agreement to pay stipulated royalties is taxable on all such payments as ordinary income. In such a case, the cash bonus payment is regarded as an advance royalty pay-

ment subject to the depletion allowance as respects the lessor or sublessor, though it represents a capital investment by the lessee or sublessee in oil and gas in place, returnable tax-free to him by way of depletion deductions spread over the productive life of the lease asset in his hands. That conclusion rests on the analogy between the receipt of such advance royalty payments and substantial cash payments received by the lessor upon the execution of an ordinary lease, which payments are regarded as advance rental payments taxable as ordinary income. Thus, in connection with the instant issue, as in the cited opinion, the fact that the assignee acquires an asset which potentially qualifies as a capital asset in his hands does not require the conclusion that the assignor parted with such an asset.

In-oil payment rights, royalty rights, and operating rights are analogous in that they are essentially rights to production income characterized as ordinary income when realized. All are regarded as depletable economic interests in oil and gas in place entitling the owner to tax-free return of his investment through the depletion allowance. In-oil payment rights are distinguishable from royalty interests and operating rights in that the latter interests, by definition, extend to the entire oil and gas resource content of the land and, as such, represent forms of fractional property rights into which the property interests in oil and gas in place are commonly divided, whereas an in-oil payment right is a right to income for a lim-

ited time or amount. This difference is emphasized by the fact that an in-oil payment right may be carved out of either of the specified property interests in oil and gas in place, but the reverse is not true. Thus, sales of royalty rights or operating rights are sales of property rights, whereas assignments of in-oil payment rights carved out of such property rights, are, with respect to the assignor, essentially mere assignments of expected income from such property rights for a fixed or determinable period of time.

The issue presented by such assignments of expected income between strangers in interest, presumptively at their present worth, should not be confused with the question presented in such cases as Lucas v. Earl (281 U.S. 111), Helvering v. Horst (311 U.S. 112, Ct. D. 1472, C.B. 1940-2, 206) and Helvering v. Eubank (311 U.S. 122, Ct. D. 1473, C.B. 1940-2, 209), involving donative assignments of income by the earner thereof in an attempt to divide his income between himself and members of his family. There the earner-assignor's attempt is to avoid realization of expected income. Here the assignor expedites such realization. See *Herman M. Rhodes* v. *Commissioner* (43 B.T.A., 780, affirmed, 131 Fed. (2d), 50), wherein the United States Board of Tax Appeals (now The Tax Court of the United States) held that a stockholder's "exercise of his power to sell or assign his right to receive the declared dividend constituted a realization of income by petitioner (stockholder) taxable to him as ordinary income."

In principle the assignment of a right to a dividend seems indistinguishable from assignments of other rights to expected income. Assignments of income rights by the earner for cash or property, measured by the then worth of such rights, may not be disregarded, and as respects such earner-assignor, he has elected to anticipate normal realization by assigning or discounting such right. Consideration received by him represents ordinary income realized by him upon the anticipatory assignment of his right to income. Once such rights to income from property or for services are separated from the earner by his act of assignment, they become property rights owned by the purchaser or assignee with a basis in his hands measured by the consideration paid. Thus, any discounting of the face value of the income right or claim by the earner thereof upon the assignment will result in income to the assignee when such discount is realized by him.

The stated general rule with respect to anticipatory assignments of income for cash or property seems equally applicable to assignments of income arising from royalty or operating property rights in oil and gas in place. As noted above, the characterization of a transaction as a purchase in the case of the assignee is not inconsistent with treating it as a mere anticipatory realization of ordinary income to the earner. That is true under the general rule pertaining to such assignments as well as to cases of grants of depletable interests in oil and gas in place for advance

royalty payments made to obtain such grants under oil and gas leases. Similarly, it is immaterial that the assignment of income vests a depletable right in the assignee. The right to depletion, as such, is not transferred. The assignor, on receipt of the anticipated income thereby realized, is entitled to the depletion allowance which is designed to compensate him for the diminution of his interests sustained by the conversion of capital into ordinary income thereby affected. Thus, qualification of the assigned right as a depletable right in the hands of the assignee springs from the character of the right rather than from the transfer. To the extent that there is a shift of depletable interest, it is analogous to the corresponding shift resulting from a cash bonus or an advance royalty payment made to obtain an oil and gas lease. In both instances, the assignor or grantor is entitled to a depletion allowance which attends the income thereby realized by him, and the assignee, in both instances, acquires a depletable economic interest in oil and gas in place.

For the reasons stated, it is the opinion of this office that consideration (not pledged for development) received for the assignment of a short-lived in-oil payment right carved out of any type of depletable interest in oil and gas in place (including a larger in-oil payment right) is ordinary income subject to the depletion allowance in the assignor's hands. No opinion is expressed with respect to the status of in-oil payment rights extending over a substantial portion of

the life of the depletable economic interests from which such rights are carved. (Emphasis supplied).

J. P. Wenchel,
Chief Counsel,
Bureau of Internal Revenue.

I.T. 3895

C.B. 1948-1, p. 39

Internal Revenue Code

Application of G.C.M. 24849 (C.B. 1946-1, 66).

G.C.M. 24849 (C.B. 1946-1, 66) holds (syllabus) that consideration received for the assignment of a short-lived in-oil payment right carved out of any type of depletable interest in oil and gas in place is ordinary income subject to the depletion allowance where such consideration is not pledged for use in further development.

Pursuant to authority contained in section 3791(b) of the Internal Revenue Code, G.C.M. 24849, supra, will be applied only to such assignments made on or after April 1, 1946.

Geo. J. Shoeneman,
Commissioner of Internal Revenue.

Approved February 24, 1948.
A.L.M. Wiggins,
Acting Secretary of the Treasury.

I.T. 4003, C.B. 1950-1, p. 10

INTERNAL REVENUE CODE

Assignments of in-oil payment rights

Advice has been requested with respect to the phrase "short-lived in-oil payment rights," as used in G.C.M. 24849 (C.B. 1946-1, 66) and I.T. 3935 (C.B. 1949-1, 39).

G.C.M. 24849, supra, expresses the opinion that consideration received for the assignment of a short-lived in-oil payment right carved out of any type of depletable interest in oil and gas in place is ordinary income to the assignor unless such consideration is pledged for use in further development. As a precaution, pending further consideration of the feasibility of distinguishing between short-lived and long-lived in-oil payment rights, the statement was made in G.C.M. 24849 that: "No opinion is expressed with respect to the status of in-oil payment rights extending over a substantial portion of the life of the depletable economic interests from which such rights are carved."

After careful study and considerable experience with the application of G.C.M. 24849, supra, it is now concluded that there is no legal or practical basis for distinguishing between short-lived and long-lived in-oil payment rights. It is, therefore, the present position of the Bureau that the assignment of any in-oil payment right (not pledged for development), which extends over a period less than the life of the depletable property interest from which it is carved, is essentially the assignment of expected income, from such property interest. Therefore, the assignment for a consideration of any such in-oil payment right results in the receipt of ordinary income by the assignor which is taxable to him when received or accrued, depending upon the method of accounting employed by him. Where the assignment of the in-oil payment right is donative, the transaction is considered as an assignment of future income which is taxable to the donor at such time as the income from the assigned payment right arises.

Notwithstanding the foregoing, G.C.M. 24849, supra, and I.T. 3935, supra, do not apply where the assigned in-oil payment right constitutes the entire depletable interest of the assignor in the property or a fraction extending over the entire life of the property. (Emphasis supplied).

I.T. 4093

C.B. 1952-2, p. 130

Internal Revenue Code

An exchange of a producing oil lease extending until the exhaustion of the deposit, which lease is held for productive use in trade or business or for investment, for the fee interest in an improved ranch to be held for productive use in trade or business or for investment constitutes an exchange of property for property of a like kind under section 112 (b)(1) of the Internal Revenue Code to the extent of the ranch land and permanent improvements thereon, but not including that part of the ranch property consisting of the personal residence, equipment, and livestock.

Advice is requested whether the exchange of a producing oil lease extending until the exhaustion of the deposit for the fee interest in an improved ranch qualifies as an exchange with respect to which no gain or loss is recognized under section 112(b)(1) of the Internal Revenue Code.

Section 112(b)(1) of the Internal Revenue Code provides in part as follows

(1) Property held for productive use or investment.—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale * * *) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

Section 29.112(b)(1)-1 of Regulations 111 provides in part as follows

Sec. 29.112(b)(1)-1. Property held for Productive Use in Trade or Business or for Investment.—As used in section 112(b)(1), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for such fact relates only to the grade or quality of the property and not to its kind or class. * * *

No gain or loss is recognized if * * * a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate * * *.

Section 112(b)(1) of the Code does not apply to property held for trading purposes or for personal use.

It is the position of the Bureau that the interest of a lessee in a producing oil lease extending until the exhaustion of the deposit constitutes an interest in real property for Federal income tax purposes. (See I.T. 3693, C.B. 1944, 272, and Palmer v. Bender, 287 U.S. 551, Ct. D. 641, C.B. XII-1, 235 (1933).)

In *Kate J. Crichton* v. *Commissioner* (42 B.T.A. 490, acquiescence, C.B. 1952-1, 2, affirmed, 122 Fed. (2d) 181), it is held that under article 112(b)(1)-1 of Regulations 94, which article is substantially the same as section 29.112(b)(1)-1 of Regulations 111, an exchange of oil, gas, and mineral rights for an undivided one-half of the fee in a parcel of improved realty was an exchange of properties of a like kind under section 112(b)(1) of the Revenue Act of 1936 (identical to section 112(b)(1) of the Internal Revenue Code.) *The United States Circuit Court of Appeals concluded that under the regulations and the interpretation therein, "the distinction intended and made by the statute is the broad one between classes and characters of properties, for instance, between real and personal property," and that "it was not intended to draw any distinction between parcels of real property however dissimilar they may be in location, in attributes and in capacities for profitable use."*

In the Crichton case, the United States Board of Tax Appeals (now The Tax Court of the United States) distinguished its decision in *Midfield Oil Co.* v. *Commissioner* (39 B.T.A. 1154, acquiescence, C. B. 1939-2, 25), in which it held that an exchange of an oil payment right for an overriding oil and gas royalty reserved from the same lease was not an exchange of property of like kind. The Board pointed out that an oil payment was a limited interest in the property, whereas an overriding royalty was to continue so long as oil or gas might be produced. In other words, an oil payment is a limited interest that is not attributable to the entire natural resource in the property as in the case of an overriding royalty. Therefore, the decision in the Crichton case is not regarded as affecting the conclusions reached in the Midfield Oil case.

In view of the foregoing, it is held that an exchange of a producing oil lease extending until the exhaustion of the deposit, which lease is held for productive use in trade or business or for investment, for the fee interest in an improved ranch to be held for productive use in trade or business or for investment constitutes an exchange of property for property of a like kind under section 112(b)(1) of the Internal Revenue Code to the extent of the ranch land and permanent improvements thereon, but not including that part of the ranch property consisting of the personal residence, equipment, and livestock. (Emphasis supplied).

Rev. Rul. 55-749

1955 C.B.-2, p. 295

Where under applicable state law, water rights are considered real property rights, the exchange of perpetual water rights for a fee interest in land constitutes a nontaxable exchange of property of like kind within the meaning of section 1031(a) of the Internal Revenue Code of 1954, provided the requirements of that section as to holding for productive use in the trade or business or for investment are met.

Advice has been requested whether the exchange of perpetual water rights for a fee interest in land under the circumstances set forth below constitutes a nontaxable exchange of property of like kind within the purview of section 1031(a) of the Internal Revenue Code of 1954.

"A" is the owner in fee of 20 acres of arid land, all of which is in an irrigation district, but he is not entitled to receive water from such district facilities. "B" has a contract with the irrigation district whereby he has the right to "petition into" such district a specified number of acres of arid land for perpetual irrigation purposes. "B" has agreed to petition the 20 acres of arid land owned by "A" into the irrigation district for water facilities in perpetuity in exchange

for one half of such land. *Under the applicable laws of the state in which the property is located, water rights are considered real property rights.*

Section 1031(a) of the Code, regarding the non-recognition of gain or loss from exchanges solely in kind, states, in part, as follows

> "* * * No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment."

Section 39.112(b)(1)-1 of Regulations 118, applicable to section 1031(a) by virtue of Treasury Decision 6091, C.B. 1954-2, 47, provides, in part, that the words "like kind," as used in section 1031(a) of the Code, have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class.

In the instant case, the fact that the two varieties of property, namely water rights and land, may be legally classified as real property does not of itself signify that the two are property of like nature or

character within the meaning of section 1031(a) of the Code. If there be substantial difference in the rights created in and to the respective properties, then the properties are not of like kind. See *Wm. Fleming and Bessie M. Fleming et al.*, v. *Commissioner*, 24 T.C. No. 93.[1]

In the Wm. Fleming and Bessie M. Fleming case, *supra*, the Internal Revenue Service was sustained in the view that an exchange of the fee simple title to a ranch for an in-oil payment right was not an exchange solely in kind under section 112(b)(1) of the 1939 Code. In arriving at its decision, the court stated that in comparing properties to determine their likeness within the meaning of section 112(b)(1) there must be considered not alone the nature and character of the physical properties but also the nature and character of the title conveyed or the rights of the parties therein; that from the applicable regulations the implication is clear that the rights vested in the respective grantees in and to the properties exchanged must be of the same general character or of substantial equality and, if they are not, then the properties exchanged are not of like kind within the meaning of the Code. Under the circumstances in the instant case, where the water right, whatever its size, is in perpetuity, as distinguished from a right to a specific total amount of water or to a specific amount of water for a limited period, the water rights and the land involved are regarded as sufficiently similar to con-

[1]This is the case under consideration.

stitute property of like kind within the meaning of section 1031(a) of the Code. See I.T. 4093, C.B. 1952-2, 130.

Accordingly, it is held that where, under applicable state law, water rights are considered real property rights, the exchange of perpetual water rights for a fee interest in land constitutes a nontaxable exchange of property of like kind within the meaning of section 1031(a) of the Internal Revenue Code of 1954, provided the requirements of that section as to holding for productive use in the trade or business or for investment are met. (Emphasis supplied).

APPENDIX C

Summary of Pertinent Opinions of United States Courts of Appeal

The following summary of opinions of United States Courts of Appeal is perhaps not complete, but is intended to present in chronological order at least the more pertinent of such opinions.

Alexander v. King, 46 F 2d 235 (CCA 10-1931) Certiorari denied 283 US 845

Proceeds received from sale of oil received as royalties held taxable as income and not as capital gain from sale of capital assets.

Darby-Lynde Company v. Commissioner, 51 F 2d 32 (CCA 10-1931)

"A taxpayer is not entitled, as a matter of right, to make any deductions from income for depletion on account of oil extracted and sold during a taxable year. Stanton v. Baltic Mining Co., 240 US 103, Burnet v. Thompson O & G Co., 283 US 301; United States v. Biwabik Min. Co., 247 US 116; Stratton's Independence v. Howbert, 231 US 399. Authority for such deduction must be found in the applicable statutes. Burnet v. Thompson O & G Co., supra."

Anderson v. Commissioner of Internal Revenue, 81 F 2d 457 (CCA 10-1936)

The outright sale of mineral interests, as distinguished from a lease with royalty reserved, should be treated as a sale of capital assets for purposes of taxation. In this case the Commissioner confessed error as to his attempt to hold otherwise.

Fleming v. Commissioner, 82 F 2d 324 (CCA 5th-1936)

This case involved the sale of oil and gas leases for cash with a reserved oil payment in favor of the seller. The Court said:

> "It is asserted generally that all persons who have an 'economic interest' in the oil and gas in the ground have a right to share in the depletion allowance. Palmer v. Bender, 287 US 551; Helvering v. Twin Bell Oil Syndicate, 293 US 312. But a lessee's interest is everywhere regarded as vendible real property, and the lessee may sell his lease or an interest in it and may thus realize income in the way of a profit on the sale. Such income is not subject to be reduced by the percentage depletion allowance, which applies only to income arising from the operation of the well. Darby-Lynde Co v. Alexander, 51 F 2d 56.

* * * While the contract was phrased as though the lease and all the oil were sold, and as though the proceeds were to be paid back to the seller, the real essence of the transaction was that the lease was sold and all the oil *except* that whose proceeds were to come to the selling taxpayer. The conveyances executed when the cash was paid might very appropriately have *reserved or excepted* sufficient oil from one-half of that thereafter run to pay the agreed sum. It is true that no royalty to continue indefinitely was reserved, and that the reservation was limited not to so many barrels nor to such a length of time, but to so much oil as would sell for the agreed sum. But it was in effect an exception or reservation of oil. The thing sold for the cash consideration was the lease and all the oil except that so reserved."

Commissioner v. *Williams*, 82 F 2d 328 (CCA 5th-1936)

The holder of an oil payment reserved in an assignment of oil and gas leases is entitled to depletion with respect to his receipts applicable to the satisfaction of the oil payment.

Ortiz Oil Co. v. *Commissioner*, 102 F 2d 508 (CCA 5th-1939) - affirming 37 BTA 656 - certiorari denied 308 US 566.

In this case taxpayer corporation carved out oil payments from oil and gas leases and disposed of them for cash. Its position before the Board of Tax Appeals was that all of the income applicable to the oil payments constituted its income, as to which a depletion allowance was applicable, and that the difference between the amount received for the oil payments and the amount which they yielded to the oil payment holder was deductible over the pay-out period as interest paid by the taxpayer corporation. The Board of Tax Appeals denied this contention, holding that the transaction effected a sale of an interest in the properties against which no depletion, but only an allocable portion of costs, could be deducted, and that the depletion allowance went with the oil payments to their purchaser.

This holding was fully affirmed by the Circuit Court for the Fifth Circuit and certiorari was denied. In the Circuit Court's opinion it was stated:

> "The Board of Tax Appeals held that the transaction was not a loan and that it constituted a sale of oil in place and that, therefore, the petitioner realized a taxable gain on the transaction in the amount of $154,000 less the amount of the cost bases allocable to the oils required to discharge the oil payments. The Board further held that the petitioner was not entitled to deduct as interest, or otherwise, any part of the proceeds of oil paid to Westbrook and Thompson.

The Board's determination was correct. The money furnished by Westbrook and Thompson was not a loan. It was the cash consideration for a conveyance of stipulated proportions of oil production to the extent in value of $359,333.34 if, as, and when the oil was produced. The portions of production specified belonged to and constituted property of Westbrook and Thompson and the petitioner was only obligated to pay over and account to them when and if the oil was produced. * * *.

Westbrook and Thompson were entitled under the contract to receive specified proportions of the proceeds of oil sales or to take their actual share of the oil production. They simply acquired an interest in oil in place. The right to share in the oil produced constituted an economic interest in the properties to the extent of the amount agreed upon. Palmer v. Bender, 287 US 551.

The Board also properly held that the petitioner was not entitled to allowance for depletion on the proceeds of the sale to Westbrook and Thompson. This amount could not properly be included in the petitioner's gross income for the purpose of calculating and determining the percentage depletion allowance given by section 114(b)(3) Revenue Act of 1932. * * *

The extent of the proportion of proceeds from sales of oil received by Westbrook and Thompson constituted income to them, and the balance only constituted the gross income of the petitioner. * * * The petitioner was entitled to a depletion allowance deduction computed only on the income received by it as its portion of the oil produced in the tax year. 'The owner of an interest in the deposit is entitled to deduct for depletion of the part producing his income but may not deduct for depletion of a share belonging to another'. Thomas v. Perkins, 301 US 663 * * *."

Thomas v. *Peckham Oil Company*, 115 F 2d 685 (CCA 5th 1940)

Upon the sale of producing oil and gas leases and related equipment, with the reservation of oil payment interests, the entire basis for the equipment (personal property) and an aliquot portion of the basis of the oil reserves is deductible from the consideration.

Columbia Oil & Gas Co. v. *Commissioner*, 118 F 2d 459 (CCA 5th - 1941)

This case is very similar to the Peckham Oil Company case supra. The Court said

"It is clear that Columbia retained a portion of its holdings and that the allocated cost of the retained portion may be recovered by depletion al-

lowances. Palmer v. Bender, 287 US 551; Thomas v. Perkins, 301 US 655."

Cullen v. *Commissioner*, 118 F 2d 651 (CCA 5th - 1941)

A group of oil properties were assigned—in some cases with reservation of oil payment interests and in others with reservation of unlimited overriding royalties. The Court held that depletion was allowable upon the cash consideration, and all other amounts received where unlimited overriding royalties were reserved, but that percentage depletion should not be allowed with respect to the cash consideration received where only oil payment interests were reserved.

Pettit v. *Commissioner*, 118 F 2d 816 (CCA 5th 1941)

Pettit owned various oil payment interests. He contended that he was entitled to treat the proceeds which he received from day to day sales as produced of the oil applicable to these oil payments as capital gain. The Board of Tax Appeals and the Court of Appeals denied this contention. The latter Court said:

"The Commissioner conceded that, by the contracts, petitioners acquired the right to have specified quantities of oil lifted and delivered to them above ground, and that petitioners had an economic interest in the oil which entitled them to

depletion. He conceded too that 'if petitioners had sold their contracts outright, they would have been entitled to the benefit of the capital gains provision."

Commissioner v. *Crichton*, 122 F 2d 181 (CCA 5th - 1941)

This case affirmed the holding of the Board of Tax Appeals (42 BTA 490) that the following exchange gave rise to non-recognition of gain under the Revenue Act of 1936. The transaction was thus described by the Court of Appeals:

> "In 1936, respondent and her three children, owning, in undivided interests, a tract of unimproved country land and an improved city lot, effected an exchange of interests. Her children transferred to respondent their undivided interest in the city lot. Respondent transferred to her children, as of equal value, an undivided 3/12 interest in the 'oil, gas and other minerals, in, on and under, and that may be produced from' the country land."

The Court first held that the applicable statutory provision was so general in terms as to render an interpretative regulation appropriate and that the applicable Treasury Regulation is Article 112(b)(1)-1 Treasury Regulations 94). and said:

"For the regulation and the interpretation under it, leave in no doubt that no gain or loss is realized by one, other than a dealer, from an exchange of real estate for other real estate, and that the distinction intended and made by the statute is the broad one between classes and characters of properties, for instance, between real and personal property. It was not intended to draw any distinction between parcels of real property however dissimilar they may be in location, in attributes and in capacities for profitable use."

Commissioner v. *I. A. O'Shaughnessy, Inc.*, 124 F 2d 33 (CCA 10th - 1941)

The taxpayer corporation had acquired several oil payments, at least some of which were carved out payments. The question was as to the taxpayer's right to depletion with respect to the amounts received from the oil applicable to these oil payments. The Court went extensively into the Supreme Court decisions as to economic interest and the right to a depletion allowance, and said:

"Thus it is made abundantly clear that one who acquires by contract, in whatever form, a right to the production from an oil and gas well, or the proceeds thereof until a stipulated amount has been paid, without any other or further security except the contingency of the production, thereby becomes the owner of an economic inter-

est in oil in place, depletable under Section 23(m), 114(b)(3)."

Lee v. *Commissioner of Internal Revenue*, 126 F 2d 825 (CA 5th) - 1942

This case involved the method of computing the allowance for depletion with respect to several oil payments. The holding in 42 BTA 1217 was affirmed. The Court said:

> "In an opinion fully finding the facts and developing the principles thought to be controlling, as to oil payment contracts petitioners had acquired at different times and under different circumstances, the Board declared: that the interest of petitioner was an interest in the oil in place; 'that they must look to depletion for the recovery of their cost and may not recoup cost out of production before being required to report any of the proceeds as gross income' * * *.
>
> The administrative and judicial view and treatment of oil payments as to cost recovery, has little by little more closely identified them with oil royalties. The resemblances between the two have outweighed the differences and it has been finally determined as to them both; that taxpayers make capital investments in oil and gas in place, alike whether they acquire royalties or oil payments; that the production oil and gas, for the benefit

of royalty and oil payment owners is an income producing operation, not a conversion of capital investment; and that as to each, for the recovery of cost, depletion must be alone looked to. Anderson v. Helvering, 310 US 404; Pettit v. Com'r 118 F 2d 816; Columbia Oil & Gas v. Com'r, 118 F 2d 459; Com'r v. O'Shaughnessy, Inc., 124 F 2d 33.

It being the accepted view now that the receipts of oil payments are the result of an income producing operation, and not of one which merely returns capital, it follows that the theory upon which the Laird case (91 Fed 2d 498) was rested, that the receipts of oil payments were returns, not of income but of capital, has fallen and that the case must be regarded as overruled. The order of the Board was right. It is affirmed."

Commissioner of Internal Revenue v. *Rowan Drilling Company*, 130 F 2d 62 (CA 5) - 1942

This case involved the treatment of carved out oil payments received by a drilling contractor as the consideration for drilling wells. The Court said:

The Board of Tax Appeals agreed with the Commissioner that the costs incurred in the drilling of three wells for oil payments were capital investments rather than ordinary business expenses;

and it agreed with the taxpayer that percentage depletion deductions should have been allowed with respect to its income derived from the oil payments.

We think the conclusions reached by the Board were correct in both instances, and that its order should be affirmed. It is no longer open to doubt that the ownership of oil in place is a capital asset, and that the acquisition price of the asset, whether paid in cash or services, is a capital investment that may not be treated as a business expense for income tax purposes, but must be recouped by depletion deductions from gross income." Citing Palmer v. Bender, 287 US 551; Thomas v. Perkins, 301 US 655; Aenderson v. Helvering, 310 US 401; State Consolidated Oil Co. v. Commissioner, 66 Fed 2d 648; Dearing v. Commissioner, 102 F 2d 91; United States v. Sentinel Oil Co., 109 F 2d 854.

Bankers Mortgage Company v. *Commissioner*.
141 Fed 2d 357 (CA 5th) - 1944

In this case the Court affirmed per curiam the holding of the Tax Court that a transaction by which Bankers Mortgage Company received from an oil company $300,000 and executed therefor two non-negotiable notes due on or before thirty years after date, and at the same time executed a deed of trust purporting to secure payment of these notes by an assignment of

certain oil and gas and sulphur interests, coupled with a contract permitting the taxpayer to absolve itself from liability on the notes by surrendering the properties, was a sale and not a transaction which produced depletable income.

West v. *Commissioner of Internal Revenue*, 150 F 2d 123 (CA 5th) - 1945

This case analyzed a complicated transaction to determine whether there was a sale producing capital gain or a lease producing depletable income with respect to the cash consideration paid, and upheld the Tax Court's holding that the transaction more closely resembled a leasing transaction.

Fleming v. *Campbell*, 205 F 2d 549 (CA 5th) - 1943

This case involved the applicability of *Section 112 (b)(1)* of the Revenue Code of 1939 to an exchange of carved out oil payments for a mineral interest in other lands. The Court held that the properties exchanged were of like kind under the aforesaid statutory provision and that no gain was to be recognized. The Court said:

"In the first place, both interests exchanged were interests in land. In the second place, neither interest was a 'leasehold of a fee' in the sense in which that term is used in the regulation. Both

were interests in minerals in place. Both were therefore interests in land, interests not in personal but in real property, in short, real rights.

Bearing in mind that neither the statute nor the regulation requires that the things exchanged be identical but only that they be 'of a like kind', we think it would be difficult to find interests more like in kind that are these mineral interests. Certainly if, as we held in the Crichton case, an exchange of taxpayer's undivided interest in minerals in unimproved country land for an undivided interest in improved city land, was an exchange solely for property of like kind, the exchange here of mineral interests for mineral interests was not an exchange of property of unlike kind merely because one of the mineral interests was of indefinite, the other of definite duration."

Campbell v. *Prothro*, 209 F 2d 331 (CA 5th) - 1954

The question here was whether the donation of calves relieved the donor of income when the donee disposed of the donated livestock. In distinguishing the case from *Lucas* v. *Earl*, 281 US 311 and *Helvering* v. *Horst*, 311 US 112, and other cases, the Court said:

"Here not interest due on choses in action in the year in which the assignment is made, but calves,

chattels, whose value could be realized only by a sale, were given. We have found no case, we have been referred to none holding that unrealized appreciation in the value of cattle given away would be regarded as ordinary income merely because they had no base, were kept for sale in the ordinary course of business, and when sold by the taxpayer would have been ordinary income."

Caldwell v. *Campbell*, 218 F 2d 567 (CA 5th) - 1955

This case held that Caldwell, who carved out oil payments of considerable duration out of royalty interests and sold them to a charitable Foundation, received gain taxable as long term capital gain as installments were collected. The Court refused to apply the doctrine of Lucas v. Earl, 281 US 111 to the transactions, saying:

"His (the Collector's) argument, that because the royalties out of which the in-oil payments were earned would, when received, be income to the grantor, they cannot be regarded and sold as capital assets, and transfers of them must under the teachings of the Earl case be treated as anticipatory assignments of income will not, we thing, at all do. Such arguments run counter to both the fact and law of the matter, to the fact in that the carving out and the sale or retention

of in-oil payments property to be bought and sold constitute a large part of the dealings in oil in Texas, to the law in that the decisions of State and Federal courts are to the contrary, and that the treatment normally accorded them taxwise is likewise to the contrary.

As we understand appellee's brief, he concedes that this is so where a royalty or part of it is sold, or even where the sale is of an in-oil payment, if this is all that the seller owns."

Commissioner v. *Hawn*, 231 F 2d 340 (CA 5th) - 1956

This is the last case relating to carved out oil payments decided by the United States Court of Appeals for the Fifth Circuit before the cases now under consideration by this Court reached it. Hawn had acquired by donation an oil payment interest in a substantial amount. At the time of the transaction, the unsatisfied portion thereof amounted to more than $850,000. In 1949 he entered into a contract with a building contractor for the construction of a residence for him and, in connection therewith, assigned to the contractor all of his interest in the oil payment until the contractor had received therefrom $120,000, whereupon the contractor's interest was to terminate. As a part of the same transaction the parties agreed:

"As a part of this agreement you agree to furnish me all bills for materials, labor, furnishings, etc., in connection with the above mentioned residence to the extent of $115,000.00.

It is understood and agreed that you are financing the furnishing of the above mentioned items with one of the local banks. You are to reimburse yourself for any interest paid out of the difference between the $120,000.00 oil payment and the amount you are paying for the oil payment, namely, $115,000.00 and any excess of any amount above the $115,000.00 with interest at 5% will be returned to me out of the oil payment.

Should, however, the amount of $115,000.00 plus interest at 5% exceed $120,000.00 I will personally be liable to you for such amount, * * *"

In holding that the transaction did not produce capital gain, the Court ultimately said:

"The effect was the same as though Hawn had borrowed the funds required, using the oil payments as collateral and applied the proceeds of such loans to pay the contractor, and then repaid his loans as the oil payments were received. Here this was accomplished and substantially the same thing was done through the person of the contractor. The government contends that the whole arrangement made the contractor the agent for

Hawn in the building of his house. While we need not cast it in this mold, we do find that the course of dealings did not amount to a sale or exchange of capital assets under section 117."